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# Determination of the Role of the Corporate Federal Income Tax in Financial Reporting.

Doyle Zane Williams

*Louisiana State University and Agricultural & Mechanical College*

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**DETERMINATION OF THE ROLE OF THE  
CORPORATE FEDERAL INCOME TAX IN  
FINANCIAL REPORTING.**

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DETERMINATION OF THE ROLE OF THE CORPORATE  
FEDERAL INCOME TAX IN FINANCIAL REPORTING

A Dissertation

Submitted to the Graduate Faculty of the  
Louisiana State University and  
Agricultural and Mechanical College  
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in

The Department of Accounting

by

Doyle Zane Williams

B.S., Northwestern State College of Louisiana, 1960

M.S., Louisiana State University, 1962

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## ABSTRACT

Unquestionably, the federal income tax charge has become one of the most significant financial burdens of U. S. corporations. For this reason, the action of management, investors--both present and potential--creditors, labor organizations, and government agencies are influenced to a large degree by the resulting income tax consequences of alternative courses of action. Each of these groups have a critical need to be informed as to the impact of federal income taxes on the enterprises's operations and financial position of the past, present, and future.

The premise of this study is that financial accounting has failed to develop realistic, logical, and practical solutions to certain problems of reporting the financial impact of the corporate income tax charge, particularly when there is a difference in timing of revenue and deductions for accounting and tax purposes. The purpose of this investigation has been to determine the appropriate reporting treatment of the income tax charge which would best fulfill the utilitarian role of financial reporting to third parties and at the same time be consistent with the existing framework of accounting theory.

In order to provide a framework for evaluating existing practice and theory, this investigation first highlighted the key aspects of (1) the purpose of financial reporting, and (2) the theoretical

structure of the balance sheet and income statement. It was suggested that the purpose of financial reporting is to present in a concise form reliable, relevant information concerning the financial affairs of an enterprise which may influence the reader in deriving conclusions concerning the earning potential and present financial position of the enterprise.

Historically, accountants have been divided in opinion as to whether the income tax charge is a cost or a distribution of profit. Because of the implications of either viewpoint, this study made a brief examination of the accounting and economic nature of the annual income tax charge. The conclusions reached suggests that the income tax charge is an expense and not a sharing of profit and should be reported accordingly.

The next section of the study concerned the problem of interperiod tax allocation. This problem is caused by a difference in the timing of the inclusion of revenue and/or deductions for financial and tax accounting. This study synthesized the arguments embracing interperiod tax allocation and concluded that the practice of allocation results in a more useful and accurately measured earnings figure. The recommendation of this investigation is that the deferred tax accounts arising from timing differences be related to the account which gave rise to the deferral in the first instance.

It is generally agreed that the role of the investment tax credit in financial reporting is in a state of confusion at this time. Since the managerial decision to purchase the asset is presumed to have been

made fully cognizant of all the benefits acquired, including the investment tax credit, it seems reasonable that these purchased benefits should be allocated as nearly as possible over the productive life of the asset.

Finally, this study concluded that prevailing accounting practice and theory concerning the accounting for net operating loss carrybacks is sound. In accounting for net operating loss carryovers, however, accounting practice has abdicated its responsibility. While many times loss carryovers are the most valuable assets firms possess, such information is tucked away in a hard to find, and understand, footnote, if reported at all. To the extent that operating loss carryovers possess expected future economic benefits via tax reductions, they should be reported as assets. Such a treatment is consistent with contemporary accounting theory and achieves a greater degree of utility in financial reporting.

## CHAPTER I

### INTRODUCTION

The impact of the tax consequences of transactions have generally been either only partially recognized or completely ignored by accountants in the preparation of the two principal financial statements, the balance sheet and the income statement. Consequently, in many cases inadequate financial reporting to third parties has resulted.

#### A. AN OVERVIEW OF THE PROBLEM

Deficient financial reporting of the effects of income taxes on business operations has reached a state of grave concern. This is partly attributable to the federal income tax charge becoming one of the most significant financial burdens of U. S. corporations. For the period July 1, 1961, to June 30, 1962, 553,873 U. S. corporations reported a total taxable income of \$47,937,691,000 paying \$22,188,057,000 federal income taxes into the U. S. Treasury's coffers. For firms reporting a net profit, in the aggregate, federal income tax charges exceeded every other single corporate deduction, including depreciation (cost of sales, of course, excepted).<sup>1</sup> For 1965 every corporation which reports a taxable income of \$25,000 or less must pay 22 cents of every

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<sup>1</sup>United States Treasury Department, Internal Revenue Service, Statistics of Income, 1961-62 (Washington, D. C.: United States Government Printing Office, 1964), pp. 17, 205.



dollar of such income to the federal government. In addition, for taxable income above \$25,000, the corporate tax rate is 48 percent. Hence, the federal government shares very significantly in the earnings of U. S. corporations. The materiality factor alone is reason enough to warrant a critical evaluation of the issues allied with the financial reporting of the annual federal income tax charge. An unrealistic procedure can distort the reported financial position as well as the operating results.

There is another factor which demands a careful, analytical examination of the proper reporting of the financial impact of corporate federal tax provisions. It is the divergence of the tax laws from generally accepted and practiced accounting procedures. This divergence is primarily in two forms: (1) differences in specifications and (2) differences in timing. The differences in specifications affect the total taxes paid by the enterprise in that certain items of revenue are excluded from the tax or various expenses are not allowed as deductions for tax purposes. Similarly, certain items which are not considered revenues or expenses for accounting purposes may be included for tax purposes. Specification differences are sometimes referred to as permanent differences because these items do not affect the timing of the charge.

On the other hand, differences in the timing of the inclusion or exclusion of revenues and expenses do not change the total tax to be paid, assuming a given tax rate, but rather changes the time as to when the tax will be levied. If the charge for income taxes is based on

taxable income, the shifting of the inclusion or exclusion of revenues and expenses between periods as permitted by the tax law will change the tax charge for a given period from the amount it would have been had the charge been based on the reported accounting income. A recent report by the Federal Power Commission provides an indication of the magnitude and resulting impact of timing differences upon the financial statements. The FPC reported that for the ten-year period ended December 31, 1963, accumulations resulting from only depreciation timing differences for Federally regulated electric power and natural gas companies amounted to \$2,125,000,000.<sup>2</sup>

Implicit in both specification differences and differences of timing are immense, and yet somewhat unique, financial reporting problems. Improper treatment, or even more serious, complete disregard of the consequences arising from these differences in financial reporting and tax accounting oftentimes may be grossly misleading. For example, the 1964 Annual Report of the Bendix Corporation reported a decrease in earnings before federal income taxes from \$44,689,133 in 1963 to \$41,941,122 in 1964, and yet at the same time earnings after federal income taxes increased from \$22,199,460 in 1963 to \$23,892,364 in 1964.<sup>3</sup> Even adjusting for the 2 per cent tax cut effected during this period fails to explain this seemingly paradoxical situation.

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<sup>2</sup>"The Impact of Liberalized Depreciation," The Journal of Accountancy, CXIX (March, 1965), 12.

<sup>3</sup>The Bendix Corporation, Annual Report, 1964, p. 28. A similar situation was also reported by IBM, without comment, in its Stockholders' Quarterly Report, April 12, 1965, p. 3. See also American Machine & Foundry Company, Annual Report, 1964, p. 32.

Even though some of the perplexing issues which shroud accounting for corporate federal income taxes have been recognized by accountants, unanimity of opinion is still far from being a reality. Moreover, some important financial reporting implications surrounding corporate income tax procedures have been completely ignored. This is true despite the fact that the ignored issues will often have a greater impact on the reported financial position and operating results of a firm than many of the issues presently being battered back and forth in the literature.

Logical and practical solutions to the general problems which result from the impact of income taxes on financial reports are needed. Realistic solutions consistently applied in preparing accounting reports will aid in such statements serving their full potential measure of utility to third parties.

## B. A SURVEY OF THE STUDY

### Purpose of the Study

The purpose of this research is to study the broad problems related to the impact of selected federal income tax provisions on the two major corporate financial reports--the balance sheet and income statement. The first objective of the study is to determine which information resulting from a divergence of accounting procedures and tax provisions should be reported. The second objective is to determine the appropriate presentation of the information which may prove to be of a utilitarian value to third parties. The ultimate objective

of the study is to provide a basis for reporting corporate income taxes which is consistent with the existing framework of accounting theory and practice.

### Scope of the Study

Specifically, the first section of the study briefly sets forth the general framework of financial reporting. Against this backdrop, the accounting and economic general nature of the annual income tax charge is examined in an attempt to determine its proper placement in financial reports. In order to determine the proper accounting treatment occasioned by a change in income tax rates, the available empirical evidence concerning the shifting and incidence of the corporate income tax is briefly reviewed. Also, the role of intraperiod tax allocation in financial reporting is examined.

The next section of the study considers the problem of interperiod tax allocation. This problem is caused by a difference in the timing of the inclusion of revenue and/or deductions for financial and tax accounting. This study attempts to synthesize the arguments embracing interperiod tax allocation, and, in light of the discussion of the purpose of financial reports, determine its proper place in financial reporting. In conjunction with interperiod tax allocation, the problems of tax rate changes are also examined. This investigation offers a technique for adjusting the tax deferral accounts in these circumstances.

Another problem in financial reporting has resulted from the recently instituted investment tax credit. This study reviews the

major issues involved in accounting for the investment credit in an attempt to reach a sound conclusion concerning its proper role in financial reporting.

Finally, the reporting of net operating loss carrybacks and carryovers is considered. While these provisions of the tax law may offer immense tax relief, financial accounting has seemingly accorded inadequate attention to the oftentimes substantial expected future economic benefits of operating loss carryovers. This study examines the economic nature of loss carryovers and attempts to determine their appropriate role in financial reports.

#### Limitations of the Study

The purpose and scope of this study suggests consideration of only the problems surrounding financial reporting to third parties. The information considered in this study is generally available to and utilized by management, therefore a discussion of reporting income taxes for management purposes is excluded.

Further, this study is limited to consideration of only the corporate federal income tax. Due to their diversity, consideration of the state statutes would lend very little additional benefit to a study of this nature. The primary concern is, moreover, limited to the Internal Revenue Code as amended through 1964. While selected related specification differences between tax accounting and financial accounting are briefly analyzed, the main theme of this study focuses upon the financial reporting problems arising from differences in timing. Finally, the purpose here is to appraise realistically the impact of

corporate income taxes on financial reporting within the framework of generally accepted accounting principles and the tax law as established.

## CHAPTER II

### THE THEORETICAL STRUCTURE OF FINANCIAL REPORTING

Historically, the main function of accounting has been to accumulate financial data. More recently, however, the dynamic function of accounting has emerged to take its proper place of importance. The new role of accounting stresses the communication of information essential to an understanding of the activities of an enterprise.<sup>1</sup> Financial reporting is a prime responsibility of contemporary accounting.

Since the techniques of financial reporting should be governed by the use to which the reports will be put, it is necessary to establish the purpose and nature of financial reporting in general before specific issues can be analyzed. In particular, the general framework of financial reporting must be reviewed in order to place the problems surrounding the reporting of the corporate income tax in their proper perspective.

#### A. THE PURPOSE OF FINANCIAL REPORTING

The purpose of financial reporting is to present in a concise form reliable, relevant information concerning the financial affairs of an

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<sup>1</sup>See Marquis G. Eaton, "Financial Reporting in a Changing Society," The Journal of Accountancy, CIV (August, 1957), 25-31.

enterprise. While this is a simple idea, the complexity of its attainment never ceases to amaze accountants. For instance take the problem of form: there is constant discussion on this one point alone. But of greater magnitude is the problem of what information is relevant.

#### Users of Financial Data

To find answers to these problems, those who prepare financial reports must first determine the users of their products. Little elaboration is needed to point out that the primary external users of financial reports are creditors, investors, stockholders, labor organizations, and governmental agencies.<sup>2</sup>

Obviously, reporting every financial detail for which all groups may have an interest is impractical. In the interest of expediency, the factors which materially affect the financial position and results of operations have become the mainstays in financial reporting. Quite naturally the distribution of general all-purpose financial statements, namely, the balance sheet and income statement, frequently connected by a statement of retained earnings, has emerged as accepted practice.<sup>3</sup>

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<sup>2</sup>While governmental agencies consume large quantities of financial statements, their chief purpose is to protect the primary users of such data, e.g., SEC, or to collect taxes. Both of these considerations are beyond the scope of this study.

<sup>3</sup>For instance, the Committee on Auditing Procedure refers to financial statements as being those "statements which purport to show financial position and results of operations; such financial statements usually consist of a balance sheet and statement of income, retained earnings, and capital." American Institute of Certified Public Accountants, Committee on Auditing Procedure, "Special Reports," Statement on Auditing Procedure No. 28 (New York: American Institute of Certified Public Accountants, 1957), p. 29.



As the arrangement and presentation of the items may be changed to suit the needs of those who use the statements, the general all-purpose statements which follow some conventional or accepted form meet reasonably well the needs of third parties.

Concurrently with the development of general purpose statements, accountants realized that financial information would be of little or no use if issued only upon the termination of an enterprise; periodic measurement and reporting was necessary. Perhaps as the year included all four seasons, it was selected as the time period for which a measurement would be taken of the financial affairs of business enterprises.

### The Selection Process

Today, as in the past, the accountant finds himself in the delicate position of determining which information, from a mass at his disposal, is relevant and pertinent in the process of annually reporting the financial position and operating results of firms. As a guideline in this selection process, the most plausible, and possibly the most desirable, course would be for the accountant to look to the uses to which the end product will be put. Horngren expressed this idea well when he wrote that:

Ideally financial statements must be constructed for maximum usefulness. Judgment as to usefulness is made ultimately by the user, not the producer.<sup>4</sup>

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<sup>4</sup>Charles T. Horngren, "Disclosure: What Next?" The Accounting Review, XXXIII (January, 1958), 92.

In other words, if any one guiding philosophy should be used in financial reporting, it should be the utilitarian value concept. Financial reports are of value only to the extent they serve a function.

#### The Value of Financing Reporting

Financial reporting generally relates events of the past--results of operations--and reports their effect on the present--statement of financial condition. The majority of users of the balance sheet and income statement find little advantage in being informed of historical events except to the extent these events are indicators of things to come--the future.

It follows, then, that the utilitarian value for external users of financial reports lies in the ability of the balance sheet and income statement to aid users of such information to make informed judgments and decisions concerning their future action. For example, not only do bondholders and stockholders depend on financial statements to provide a record of management stewardship, but in addition they use the statements as a basis in determining whether to buy, sell, or hold investments.<sup>5</sup> Labor looks to financial statements in connection with wage negotiations.<sup>6</sup> Creditors may withhold, grant or extend credit

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<sup>5</sup>See Nicholas E. Crane, "A Security Analyst Looks at Annual Reports," The Journal of Accountancy, CV (March, 1958), 31-36 and L. Hartley Smith, "A Security Analyst Looks at Financial Statements," The Journal of Accountancy, CVIII (August, 1959), 37-41.

<sup>6</sup>See Wilber F. Pillsbury, "Organized Labor's Views of Corporate Financial Information," The Journal of Accountancy, CV (June, 1958), 46-56.

on the basis of the borrower's financial ability as indicated in his financial statements. In short, financial reports must meet varying needs.

### A Balancing of Forces

As various groups have particular and even diverse interests in financial reports,<sup>7</sup> the accountant must exercise extreme care in preparing the statements as fairly and impartially as is humanly possible. In reporting to the general public, the accountant may well keep in mind the remarks of one eminent financial analyst who stated:

Management is resorting to simplified reports to inform employees and improve small-stockholder relations. But these presentations may be inadequate for even the moderately skillful statement reader to say nothing of the professional staff of the financial institution or the investment advisor. Details that dull the interest of the average reader may be essential to inform the professional. The needs of the latter should be met even at the risk of boring the average reader for a few pages. Successful financing depends upon the goodwill of the skillful minority as well as the general public.<sup>8</sup>

In brief, in setting forth guidelines for financial reporting, the accountant's ideas must be tempered by the uses to which his products will be put. As A. C. Littleton once wrote, the accountant must be ever mindful that a balancing of forces is necessary.<sup>9</sup>

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<sup>7</sup>Many of these interests are expressed in a Symposium, "What's Wrong With Financial Reporting?" The Journal of Accountancy, CXII (August, 1961), 28-33.

<sup>8</sup>Harry G. Guthmann, Analysis of Financial Statements (fourth edition; New York: Prentice-Hall, Inc., 1953), pp. 17-18. For a different viewpoint, see Edward T. McCormick, "Reporting to Stockholders," The Accounting Review, XXXV (April, 1960), 223-227.

<sup>9</sup>A. C. Littleton, Structure of Accounting Theory (n.p. American Accounting Association, 1953), p. 21.

## B. UNDERLYING CONCEPTS

In order to implement their responsibility for objective, reliable financial statements, accountants have devised several underlying concepts and assumptions.<sup>10</sup>

Certain concepts underlying financial accounting in general must be discussed in order to provide a framework which can be used to analyze rigorously the problems associated with reporting the corporate income tax charge. The concepts pertinent to this study include objectivity, conservatism, materiality, full disclosure, matching, and going concern.

### Objectivity

Accountants tend to pride themselves on reporting only facts substantiated by verifiable, objective evidence. The term, objectivity, is used to refer to the expression of facts without any distorting influence from personal bias. This is contrasted to subjectivity which implies that personal opinion plays a major role in the decision.<sup>11</sup> In adhering to the rule of objectivity, the accountant uses as his basis for recording accounting data the dollar amount of transactions

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<sup>10</sup>No attempt here is made to distinguish among assumptions, concepts, conventions, rules, principles, standards, or the numerous other terms used, quite improperly, in describing the basic framework or foundation of financial accounting. For a summary of the terminology problem, see Reed K. Storey, The Search for Accounting Principles (New York: American Institute of Certified Public Accountants, 1964), pp. 20-24.

<sup>11</sup>W. A. Paton and A. C. Littleton, An Introduction to Corporate Accounting Standards (Chicago): American Accounting Association, 1940), p. 19.

established by arm's length negotiations of intelligent, informed parties who were under no compulsion to act.<sup>12</sup> The stress of applying accounting standards to a dynamic environment, however, often results in accountants applying the above rule of objectivity with a certain degree of flexibility.

### Conservatism

Accountants often justify their particular treatment of certain transactions on the grounds of conservatism. Currently the doctrine of conservatism in accounting "is that when two or more reasonable conclusions exist, conservatism dictates the choice of the one that results in the least immediate showing."<sup>13</sup> The present procedure of reducing inventory values when market has declined below cost but the failure to countenance write-ups under reverse conditions may be attributable, in part, to conservatism. The idea is often expressed that the concept of conservatism is primarily concerned with anticipating the worst; or put differently, it is concerned with reporting favorable conditions with some reluctance and reporting unfavorable conditions immediately and emphatically.<sup>14</sup>

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<sup>12</sup>Harold E. Arnett, "What Does 'Objectivity' Mean to Accountants?" The Journal of Accountancy, CXI (May, 1961), 65.

<sup>13</sup>Arthur W. Holmes, Auditing: Principles and Procedure (sixth edition; Homewood, Illinois: Richard D. Irwin, Inc., 1964), p. 9.

<sup>14</sup>Carl T. Devine, "The Rule of Conservatism Re-examined," Journal of Accounting Research, I (Autumn, 1963), 128.

The proper role of conservatism in accounting, one researcher concluded, is to insure that the uncertainties and risks inherent in any given business situation are given adequate consideration.<sup>15</sup> A logically sound application of conservatism would call not for reporting an asset (or any other element in the accounting project) at its lowest (or highest) value which can be sustained, but for reporting a value at the highest probability of being proved correct by later events.<sup>16</sup> In any event, however, conservatism should not transcend full disclosure.

### Materiality

As previously pointed out, the reporting of every financial detail by accountants is impractical; they must resort to classification and condensation of the financial data. As their guide in financial reporting decisions, accountants follow the rule of full disclosure of all items which will materially affect the reported results.<sup>17</sup>

Obviously the question of materiality must be resolved on the basis of the surrounding circumstances and the setting within which the item in question appears. The American Accounting Association's Committee on Accounting Concepts and Standards concluded that an item

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<sup>15</sup>Maurice Moonitz, The Basic Postulates of Accounting (New York: American Institute of Certified Public Accountants, 1961), p. 47.

<sup>16</sup>John B. Canning, The Economics of Accountancy, (New York: The Ronald Press Company, 1929), as cited in Ibid., p. 48.

<sup>17</sup>A frequent exception, however, is intangibles.

should be regarded as material if there is reason to believe that knowledge of it would influence the decisions of an informed investor.<sup>18</sup>

One author recently wrote that materiality decisions should depend not only on inferences that an "average" investor might draw from financial statements, but on interpretations that might be expected from the application of the best methods of financial analysis such as averages, trends, and ratios that establish meaningful analytical relationships of information commonly found in annual reports.<sup>19</sup>

On the whole, the materiality of an item depends on its relative size, its nature, or a combination of both--all determined by the exercising of judgment.<sup>20</sup>

#### Full Disclosure

Once an item is determined to be material, it should be disclosed or reported. The influence of financial statements in the decision-making

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<sup>18</sup>American Accounting Association, Committee on Accounting Concepts and Standards, "Accounting and Reporting Standards for Corporate Financial Statements--1957 Revision," Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, (Columbus, Ohio: American Accounting Association, 1957), p. 8.

<sup>19</sup>Donald Rappaport, "Materiality," The Journal of Accountancy, CXVII (April, 1964), 48. This article includes "three specific guideposts for materiality decisions about presentation of net income, five areas of guidance for separate disclosure of extraneous items and for disclosure of lack of comparability in income statements, eight guideposts for balance sheet materiality decisions and five for disclosure of certain other data and information," p. 43.

<sup>20</sup>See Samuel M. Woolsey, "Development of Criteria to Guide the Accountant in Judging Materiality," The Journal of Accountancy, XCVII (February, 1954), 167-173, and Delmer P. Hylton, "Some Comments on Materiality," The Journal of Accountancy, CXII (September, 1961), 61-64.

process of many groups has already been indicated. For a great many persons, the financial statements are their only source of information concerning the status of an enterprise. The accountant, aware of the needs of these groups, can make the statements useful by reporting all of the data at his disposal that are required in reaching informed opinions. In meeting his reporting responsibilities, the accountant should remember that such data are not limited to matters of the past and the present, but, under certain circumstances, include matters relating to the future.<sup>21</sup> For proper disclosure, as is true of many of the other accounting concepts, there is no substitute for sound judgment.<sup>22</sup>

### Matching

As previously pointed out, theoretically the most accurate financial reports can be rendered upon the termination of the business enterprise. Practically, however, such a delay in financial reporting would provide little, if indeed any, value to those who are interested in the financial affairs of a business concern. Therefore, periodically the accountant must divide the stream of costs incurred between the present and the future to be matched against the measured revenue stream of the enterprise.

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<sup>21</sup>Harry Simons and Wilbert E. Karrenbrock, Intermediate Accounting (fourth edition; Cincinnati: South-Western Publishing Company, 1964), p. 51.

<sup>22</sup>See Charles H. Griffin and Thomas H. Williams, "Measuring Adequate Disclosure," The Journal of Accountancy, CIX (April, 1960), 45.



The central theme of matching is that expired costs should be assigned to the income statement while unexpired costs should be reported in the balance sheet to be assigned in subsequent periods. The implementation of this concept caused Paton and Littleton to conclude that "matching costs and revenues is primarily a problem of finding satisfactory bases of association; the essential test is economic reasonableness, rather than physical measurement."<sup>23</sup> As was observed concerning disclosure, the accuracy of matching will depend, to a very large extent, on the accountant's carefully exercised judgment and interpretation, rather than upon a definitely determinable amount of outlay per period.

#### Going Concern

The matching process, like many other accounting concepts, is predicated upon the continuity of existence assumption, i.e., in the absence of contrary evidence, the life of a business enterprise is assumed to be indefinite.<sup>24</sup> This assumption, often called the going concern concept, conforms to the usual expectations of enterprise owners and managers; possible liquidation is not the usual expectation while continuity is.<sup>25</sup> This assumption exerts a great influence on the

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<sup>23</sup>Paton and Littleton, op. cit., p. 65.

<sup>24</sup>Moonitz, op. cit., p. 39, warns against identifying the continuity assumption or "going concern" concept with "permanence." "Permanence means, fundamentally, that economic activity of some sort or other will be carried on as long as human beings inhabit this planet. It is, therefore, much too sweeping a concept to serve as a guide to action."

<sup>25</sup>Paton and Littleton, op. cit., p. 9.

manner in which accountants report asset values in the financial statements. Later sections of this study will develop in detail the role of the continuity assumption in reporting income taxes.

A background knowledge concerning the concepts of objectivity, conservatism, materiality, full disclosure, matching, and going concern is pertinent to an understanding of the underlying basis of contemporary financial reporting. These concepts form the foundation for the structure of the balance sheet and income statement--the principal general-purpose financial statements.

### C. THE STRUCTURE OF FINANCIAL REPORTS

Although the balance sheet and income statement are the principal statements, an analysis of changes in retained earnings sometimes appears in published reports as a third statement. Other statements receiving recent attention include sources and disposition of funds and cash flow statements. While these "extras" do serve a specific purpose, they, as yet, have not the universal importance of the balance sheet and income statement. And these are the statements which pose the greatest problem in reporting income taxes. In order to gain a perspective of the problems of presentation associated with accounting for income taxes, a review of the existing theoretical structure of the principal financial statements composes the next section of this study.

#### Balance Sheet

The balance sheet relies on the going concern idea for much of its rationale. The continuity assumption underscores the use of historical

cost values on the balance sheet; these costs are termed unexpired costs and at the time they become expired, they will be transferred to the income statement, e.g., equipment and depreciation.

Whereas original cost is strictly adhered to for some assets, particular fixed assets, current market values are used for other assets like inventories and temporary investments whose market values are less than their cost. Consequently, in lieu of a precise, clear-cut definition of the balance sheet, about the only conclusion that can be made about this statement is that it is a pool of values, both historical and current, at a point in time. It reflects the resources, called assets, of the business enterprise and the claims or rights attaching to the enterprise. These claims are of a two-fold nature, those of third parties called liabilities, and those of the owners, called owners' equity. These major balance sheet sections are in turn further classified into greater detail.

The general term, assets, has been defined in various ways. Perhaps the most narrow and technical meaning given is that of the American Institute of Certified Public Accountants.

Something represented by a debt balance that is or would be properly carried forward upon a closing of books of account according to the rules or principles of accounting (provided such debit balance is not in effect a negative balance applicable to a liability), on the basis that it represents either a property right or value acquired, or an expenditure made which has created a property right or is properly applicable to the future.<sup>26</sup>

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<sup>26</sup>American Institute of Accountants, Committee on Terminology, "Review and Resume," Accounting Terminology Bulletin No. 1 (New York: American Institute of Accountants, 1953), p. 13 reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

A more functional definition of assets is given by the American Accounting Association. This body feels that assets are simply economic resources devoted to business purposes within a specific accounting entity. They are aggregates of service-potentials that are available for or beneficial to expected operations.<sup>27</sup>

Sprouse and Moonitz summed up the nature of assets as being two-fold. First, assets represent expected future economic benefits, and second, they must have been acquired by the enterprise as a result of some current or past transaction.<sup>28</sup> The assets of an enterprise are generally classified in their order of liquidity.

Current assets. As current assets are usually considered the most liquid of all assets, the usual arrangement, except for public utilities, places them first in the balance sheet.

It is frequently stated that current assets include those resources which are reasonably expected to be (1) realized in cash, (2) sold, or (3) consumed during the normal operating cycle of the business. Some accountants maintain that prepaid expenses are also included in this category of assets not because they will be converted into cash but because if not paid in advance, they would require the use of current

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<sup>27</sup>American Accounting Association, op. cit., p. 3.

<sup>28</sup>Robert T. Sprouse and Maurice Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprises (New York: American Institute of Certified Public Accountants, 1962), p. 54.

assets during the operating cycle of the enterprise.<sup>29</sup> Obviously, such a criterion for classifying prepaid expenses is unsound because if any asset is not paid for in advance it will almost always require the use of current funds for its acquisition. A more logical criterion seems to be one determined on the basis of time. That is, if the future economic benefit is expected to be realized or is assignable to revenue in the next operating cycle or fiscal year of the firm, then a current classification is in order. Otherwise, a non-current designation is appropriate.

Investments. The next most liquid assets are considered to be investments. This sub-classification generally includes resources held for such long-term purposes (beyond the normal operating cycle) as regular income, appreciation, or ownership control.<sup>30</sup> In addition, this class heading best describes certain types of prepayments which apply beyond the next operating or fiscal year of the firm.

Plant and equipment. Plant assets are described as those tangible assets of a relatively fixed or permanent nature that are used in the operations of a business. It is implied, of course, that

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<sup>29</sup>American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins" Accounting Research Bulletin No. 43 (New York: American Institute of Accountants, 1953), p. 20 reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

<sup>30</sup>Simons and Karrenbrock, op. cit., p. 12.

such assets are not held for sale.<sup>31</sup> Included under this heading are land, building, machinery, and equipment.

Intangibles. As a class of assets, intangibles possess characteristics similar to other assets with one difference. The value of intangibles does not derive from their physical nature but from the right conferred by their ownership.<sup>32</sup> Examples include patents, copyrights, and trademarks.

Other assets. Occasionally accountants encountered non-current assets which they improperly classify as other assets. Such a classification has no place in informative financial reporting because the true nature of the items listed therein is not revealed. The practice of including an "other assets" classification on the balance sheet is a deterrent to proper analysis of the financial position of a firm. In short, the utilitarian role of financial reporting is not served by utilizing such an ambiguous class-heading as other assets.

Deferred charges. In a few instances, a class heading called deferred charges is encountered as the last classification for assets in the balance sheet. Finney and Miller defined deferred charges as those charges which are to be used in the determination of net income of subsequent periods covering a time span of more than an operation cycle.<sup>33</sup>

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<sup>31</sup>C. Rollin Niswonger and Philip C. Fess, Accounting Principles (ninth edition; Cincinnati: South-Western Publishing Company, 1965), p. 251.

<sup>32</sup>James H. Rossell and William W. Frasure, Managerial Accounting (Columbus, Ohio: Charles E. Merrill Books, Inc., 1964), p. 16.

<sup>33</sup>H. A. Finney and Herbert E. Miller, Principles of Accounting--Intermediate (fifth edition; Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1958), p. 48.

Some accountants quite legitimately object to a deferred charges designation on the grounds that this designation could be applied to all costs assignable to future periods including inventories, plant and equipment, and intangibles.<sup>34</sup> Accordingly, there is little, if indeed any, justification for such a designation for assets. It is hoped that the deferred charges classification as well as the "other assets" designation will continue to dwindle from the accounting scene.

There are two classes of claims against the accounting entity--those of creditors and owners. The creditors' claims are more generally known as liabilities.

Liabilities may be defined as claims against the enterprise arising from past activities or events which usually require corporate resources for their discharge.<sup>35</sup> Liabilities are usually discharged through conveying assets or performing services at some future date.<sup>36</sup>

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<sup>34</sup>Simons and Karrenbrock, op. cit., p. 13.

<sup>35</sup>American Accounting Association, op. cit., p. 7. The American Institute of Certified Public Accountants Committee on Terminology defines the term "liabilities" very broadly to include "not only items which constitute liabilities in the popular sense of debts or obligations (including provision for those that are unascertained) but also credit balances to be accounted for which do not involve the debtor and creditor relation. For example, capital stock and related or similar elements of proprietorship are balance sheet liabilities in that they represent balances to be accounted for, though these are not liabilities in the ordinary sense of debts to legal creditors," American Institute of Accountants, Committee on Terminology, op. cit., p. 14.

<sup>36</sup>Sprouse and Moonitz, loc. cit.

For recognition in the accounts, some accountants feel that the amount of the liability should be subject to calculation or close estimation.<sup>37</sup>

In brief, liabilities are distinguished from other accounting recognitions by three features: (1) they are nonowner equities, claims, interests or asset reservations, (2) they generally involve future asset expenditure for their settlement, and, according to one accountant, (3) they should relate to assets already recognized.<sup>38</sup> In general, liabilities represent legal obligations established by some current or past event.

Current liabilities. The usual first sub-heading for liabilities is reserved for those items of a current nature. Some accountants have set forth a rather questionable basis for classifying items as current liabilities; they have stated that obligations are properly categorized as current liabilities if their liquidation is expected to require (1) the use of resources classified as current assets, or (2) the creation of other current liabilities. It is further stated that obligations for items which have entered into the operating cycle or debts that have arisen directly from operations related to the operating cycle are also properly classified as current liabilities.<sup>39</sup>

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<sup>37</sup>Maurice Moonitz, "The Changing Concept of Liabilities," The Journal of Accountancy, CIX (May, 1960), 44.

<sup>38</sup>Wendell P. Trumbull, "When is a Liability?" The Accounting Review, XXXVIII (January, 1963), 46.

<sup>39</sup>American Institute of Accountants, Committee on Accounting Procedure, op. cit., p. 21.



Such a basis for classifying obligations as current is open to serious question because nearly all debts require cash for their settlement. Scarcely any accountants would agree that all obligations are always to be considered current liabilities. To overcome this objection, it seems that a more functional approach to liability classification is to consider current liabilities simply as those accounts which will be settled or assigned to the income measurement process within the next fiscal year or operating cycle.

Long-term liabilities. Some accountants maintain that obligations which will not require current assets for their discharge are properly reported as long-term liabilities. This basis for classifying liabilities is also subject to serious objections. There are some items which may not actually require assets listed as current as of the balance sheet date which nevertheless are expected to be paid during the next fiscal year. Therefore, such items should be classed as current liabilities rather than long-term. Consequently, a more satisfactory scheme would seem to be to classify as long-term liabilities those accounts with credit balances which will not be settled or assigned to the income measurement process within the next fiscal year or operating cycle.

Deferred credits. Another section for liabilities is sometimes provided on the balance sheet which is called either deferred credits, deferred revenues, or occasionally deferred income, the latter being entirely a misnomer.<sup>40</sup>

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<sup>40</sup>W. A. Paton, "'Deferred Income'--A Misnomer," The Journal of Accountancy, CXII (September, 1961), 38-40.

It is usually held that items to be listed under this class heading are credits that are to be included in the determination of net income of subsequent periods covering a time span in excess of an operating cycle.<sup>41</sup>

Many accountants object to a deferred credits designation for liabilities on the grounds that many of the items which are generally included in this balance sheet section are more properly offsets to some asset accounts. Moreover, it is frequently pointed out that a deferred credit classification poses a special hardship on the financial analyst in attempting to interpret the financial condition of an enterprise. For example, how are deferred credits to be treated in conventional ratio analysis of the balance sheet? Indeed, it does seem difficult to justify such a designation, and its gradual disappearance seems to be warranted.

The use of a class heading entitled "other liabilities" for obligations is subject to the same criticism as outlined above for "other assets." Consequently, it seems that justification can only be offered in support of two designations for liabilities--current and long-term.

Owners' equity. The second type of equities of an enterprise is that of the owners, frequently labeled owners' equity or capital. This section, of course, represents the difference between the assets and liabilities--the residual.

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<sup>41</sup>Finney and Miller, loc. cit.

In reporting the stockholders' equity in an enterprise, a distinction is maintained between invested capital and retained earnings. Retained earnings is used to designate the portion of the owners' equity which resulted from the enterprise's endeavor to earn a profit, less the portion which have been distributed to the owners via dividends. It seems desirable that, as a general rule, all items ultimately affecting the amount of retained earnings, except for dividends, be reflected in the income measurement process--in the income statement.

The form of the balance sheet is subject to great variation. When emphasis is placed upon the enterprise's working capital position and liquidity the class headings are frequently reported in the following order:

ASSETS	LIABILITIES
Current assets	Current liabilities
Investments	Long-term liabilities
Plant and equipment	OWNERS' EQUITY
Intangibles	Paid-in capital
	Retained earnings

It seems that a more accurate interpretation of the financial condition of an accounting entity is possible if accountants would adhere to the above classification system.

Contingencies. In preparing the balance sheet, the accountant may encounter "contingencies." The Committee on Accounting Procedure defined contingencies for accounting purposes as:

an existing condition, situation or set of circumstances, involving a considerable degree of uncertainty, which may,

through a related future event, result in the acquisition or loss of an asset, or the incurrence or avoidance of a liability, usually with the concurrence of a gain or loss.<sup>42</sup>

Contingent assets would arise where there existed certain rights or claims, somewhat uncertain in character and often indeterminate in amount, that could materialize as valuable assets upon the favorable turn of certain events. Contingent liabilities would be encountered where past activities or circumstances may have given rise to possible future liabilities although legal obligations do not exist on the date of the balance sheet.<sup>43</sup>

Perhaps due to the influence of conservatism, accountants much more readily recognize contingent liabilities than contingent assets.<sup>44</sup> In fact, rarely in practice is reference ever made to contingent assets, truly an inconsistency in reporting. Contingencies which are recognized by accountants are generally reported in footnotes to the financial statements.

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<sup>42</sup>American Institute of Certified Public Accountants, Committee on Accounting Procedure, "Contingencies," Accounting Research Bulletin No. 50 (New York: American Institute of Certified Public Accountants, 1958), p. 37 reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

<sup>43</sup>Simons and Karrenbrock, op. cit., p. 14.

<sup>44</sup>"Contingencies which might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." The Committee then adds, as an apparent after-thought, "but there should be adequate disclosure." American Institute of Certified Public Accountants, Committee on Accounting Procedure, "Contingencies," op. cit., p. 38.

## Income Statement

Arrangement and content. The income statement is a financial review of the results of operations during a stated accounting period. It summarizes the revenues of the period and applicable expenses and reports the profit or loss from operations. As might be surmised, the reported net income figures have become of prime importance to the users of financial reports for such data indicates the progress of an enterprise. Unlike the balance sheet, which is a static statement, the income statement has a dynamic character inasmuch as it covers a period of time, not a point in time.

While there is general agreement that there should be a clear distinction on the income statement between those charges and credits that are normal and recurring and those that are extraordinary and nonrecurring, there is not unanimity of opinion, however, as to just how such a distinction should be made.

The all-inclusive statement. One point of view is that the income statement should report all items affecting income that have been realized or recognized during the period. The final figure would be the result of ordinary operations, extraordinary items, and corrections of income reported in prior periods. Retained earnings is freed of such charges. Under this procedure, the income statement is known as the "all-inclusive" type.

In supporting the all-inclusive type of income statement, the American Accounting Association asserts that this practice assures

that the income statements for a period of years will disclose the total income history of that period.<sup>45</sup> Likewise, the Securities and Exchange Commission also favors the all-inclusive income statement.<sup>46</sup>

The current-operating performance statement. The contrasting point of view maintains that the income statement should be restricted to normally recurring items. The supporters of the current-operating performance concept of the income statement maintain that this type of statement (1) shows results only from ordinary operations for the year and (2) it is useful in estimating future operating performance.

The American Institute of Certified Public Accountants favors this type of income statement on the grounds that the inclusion of material, extraordinary items may impair the significance of the net income so that misleading inferences might result concerning the earning power of the enterprise.<sup>47</sup> Such extraordinary items would be more appropriately disclosed, according to this viewpoint, in the statement of retained earnings.

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<sup>45</sup>American Accounting Association, Executive Committee, "Accounting Concepts and Standards Underlying Corporate Financial Statements--1948 Revision," Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus, Ohio: American Accounting Association, 1957), p. 17. See also "1957 Revision," p. 8.

<sup>46</sup>United States Securities and Exchange Commission, Regulation S-X (Washington, D. C.: United States Government Printing Office, 1961), Article 5, Rule 5-03, p. 11.

<sup>47</sup>American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," op. cit., p. 63.

#### D. SUMMARY

Financial reporting should be judiciously tailored to fulfill its utilitarian role. That is, financial statements should be of use to readers in determining their future course of action--be they stockholders, investors, creditors or labor organizations. Obviously, for financial reports to be of use to these diverse groups, the accountant must judiciously balance each of these forces which influence his financial reporting policies.

To fulfill the dynamic role of accounting--communicating the financial affairs of an enterprise to those outside the firm--accountants have devised a complex set of underlying assumptions and concepts. These include objectivity, conservatism, full disclosure, matching, and going concern. Upon the foundation of these basic concepts, the structure of financial reporting is constructed.

The balance sheet, commonly called statement of financial condition or position, is said to serve as the connecting link between the series of income statements. A functional classification of the balance sheet includes, first, assets which, in order to be of greatest use to the financial statement analyst, should be classified into one of four types: current assets, investments, plant and equipment, and intangibles. A second category for balance sheet data is that of liabilities. Sound financial reporting requires all liabilities to be classified as either current or long-term. The third section of the balance sheet, owners' equity, reflects the residual interest of the stockholders in the enterprise.

The income statement or statement of operating results, seeks to reflect the enterprise earnings for a designated accounting period. It may be prepared to reflect only "normal earnings"--current-operating performance concept--or be all-inclusive by reflecting extraordinary charges or credits and corrections of prior periods.

Against this backdrop of the purpose, underlying concepts, and structure of financial reporting, specific issues peculiar to reporting federal income taxes can be effectively analyzed. The next section of this study considers the financial and economic nature of the annual corporate tax charge and its general, and for the most part, conventional, presentation in financial reports.



## CHAPTER III

### THE NATURE OF THE CORPORATE INCOME TAX CHARGE

Now that a cursory review of the existing theoretical structure of financial accounting has been presented, a more meaningful analysis can be made of the nature of the corporate income tax charge.

Historically, accountants have been divided in opinion as to whether the income tax charge is a cost or a distribution of profit, like dividends. Perhaps the answer lies in the "economic" nature of the tax charge. That is to say, where does the burden of the corporate income tax ultimately rest? Can the tax be shifted when there is a change in rates? Answers to these questions have present-day significance because of the recent corporate tax rate changes and more revisions are contemplated. In brief, an examination of the accounting and economic nature of the tax charge may shed some light on its proper treatment in periodic financial statements.

#### A. THE ACCOUNTING NATURE OF THE TAX CHARGE

There are two schools of thought among accountants as to the nature of the annual corporate income tax charge. One viewpoint maintains that income taxes are a distribution of income--a sharing by the government in the profits as stockholders share via dividends. The contrasting point of view argues that the income tax is an expense like salary or rent expense.

As a Distribution of Income Viewpoint

Managerial efficiency. The accountants who argue that income taxes are a distribution of profits base their position essentially on the idea that the purpose of income measurement is to judge managerial efficiency. A common feature of present-day corporate organizational structure is the separation of owners from managers. Management not only wants a share in the fruits of its labor--profits--but also bases its claims upon a computation of profit figures which is best designed to show the results of managerial skill and efficiency. Thus, management has an interest in the development of the enterprise--if for no other reason than perhaps to assure them job security--different from that of the legal owners.<sup>1</sup>

Consequently, under this view only those items of cost which are subject to managerial control should be included in the determination of profit. Greer illuminated this viewpoint in writing about a company with which he was familiar.

This concern realizes an operating profit which represents a fair margin on sales and a good return on the assets utilized. It has the misfortune of having an unfavorable profit-tax base. For this reason an abnormally high percentage of its operating profits is absorbed by Federal income and profits taxes. The net return to the stockholders is unsatisfactory--not because operating profits are inadequate but because taxes are excessive.<sup>2</sup>

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<sup>1</sup>E. H. Weinwurm, "Corporate Income Taxes and the Income Statement," The Journal of Accountancy, LXXVIII (August, 1944), 148.

<sup>2</sup>Howard C. Greer in a letter to Paton on July 5, 1945, "Placement of Taxes in Income Statement," The Accounting Review, XXI (January, 1946), 86-87.

In short, it is often argued that the corporate income tax is a charge levied on managerial efficiency and is not to be considered as a cost in the measurement of this efficiency. Management has no control over the amount of the income tax charge.

The form of the tax. The viewpoint that the income tax charge is a distribution of profits is also supported on grounds other than measuring managerial efficiency. Greer, for instance, also argues that income taxes are paid for the privilege of earning a profit or income as a corporation.<sup>3</sup> If no taxable income is earned by the corporation, then no tax is paid.

The argument is made that since corporate income taxes are levied against income, it logically follows that the tax charge is participation in profits. This was the intent of the income tax laws.<sup>4</sup> Thus, the form of the tax is a relevant starting point for an analysis of the nature of the corporate income tax. For instance, had the federal government chosen to raise its revenues by taxing the property of a corporation, then clearly the tax would be an expense of doing business--it is incurred every year of operations; not so for the income tax charge for it is paid only after a profit is earned. Therefore, the conclusion is reached by some that due to its form, the income tax must be a distribution of income.

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<sup>3</sup>Ibid.

<sup>4</sup>R. E. Copman, A Symposium, "What are Corporate Income Taxes?" The Journal of Accountancy, LXXVIII (October, 1944), 304.

The government as an equity-holder. In addition to these arguments, it is held that since the federal government takes a large portion of the corporation's profits when profits are realized, and takes nothing when there are not profits, it has more of the attributes of an equity-holder than of a supplier of goods or services.<sup>5</sup> It is true that the equity of the government does not appear in the balance sheet as such but it is because the equity of the government is not in property, but in the earnings of the corporation. Greer stated that while it would not be necessary to place a balance sheet "value" on the government's equity, it may be desirable to indicate the extent to which the government does currently participate in profits. This may be accomplished by a balance sheet caption in the equity section. Thus, mere mention of the government's claim to profits would put users of the statements on notice of this "sharing of profits."<sup>6</sup>

The American Accounting Association's position. The position that income taxes are not a determinant of enterprise net income is supported by the American Accounting Association.

The realized net income of an enterprise measures its effectiveness as an operating unit and is the change in

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<sup>5</sup>Howard C. Greer, "Treatment of Income Taxes in Corporation Income Statements," The Accounting Review, XX (January, 1945), 97. Roy C. Brown went so far as to state: "My idea is that to regard the new partner's (the federal government) cut of the profits as an element of cost of operation might be a parallel and precedent for regarding withdrawals of partners as an element of cost of a business operated as a partnership." Roy C. Brown, A Symposium, "What are Corporate Income Taxes?" The Journal of Accountancy, LXXVIII (October, 1944), 305.

<sup>6</sup>Ibid.

net assets arising out of (a) the excess or deficiency of revenue compared with related expired costs and (b) other gains or losses to the enterprise from sales, exchanges, or other conversions of assets. Interest charges, income taxes, and true profit-sharing distributions are not determinants of enterprise net income.<sup>7</sup>

Although apparently the AAA's Committee's reasons were partially based upon measuring managerial efficiency, unfortunately it did not elaborate further as to the basis for its conclusions. A member of the committee, Thomas M. Hill, did, however, state that "a dollar of corporate income tax differs from a dollar of corporate wages in that the former is paid only if period revenues exceed period costs."<sup>8</sup> Hill then added, "In this respect, the tax dollar is suspiciously like the dividend dollar." Thus the argument returns full circle to the form of the tax for its basic premise.

Another writer, Eldon S. Hendriksen, speculated that one of the reasons against the inclusion of income taxes in the expense category was the assumption that the incidence of the tax is on the stockholders. It, therefore, has the character of a withholding tax

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<sup>7</sup>American Accounting Association, Committee on Accounting Concepts and Standards, "Accounting and Reporting Standards for Corporate Financial Statements--1957 Revision," Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus, Ohio: American Accounting Association, 1957), p. 8.

<sup>8</sup>Thomas M. Hill, "Some Arguments Against the Inter-Period Allocation of Income Taxes," The Accounting Review, XXXII (July, 1957), 357.

paid to the government for the shareholders.<sup>9</sup> While the incidence of the income tax is considered in the next section of this study, it is worth noting that, as David Li pointed out, the preceding argument equates the stockholders' viewpoint to the entity's, and, therefore, is not consistent with the concept that an entity is a separate and distinct unit from the owners which is a basic premise of accounting.<sup>10</sup>

In summary, the arguments for treating income taxes as a distribution of profits rather than as an expense can be classified into three categories. First, it is held that income taxes should be excluded in determining profits because the purpose of income determination is to measure managerial efficiency. Management has no control over the income taxes to be paid; therefore, this charge should not be considered in measuring the efficiency of management. Second, it is argued that the form of the income tax charge indicates that it is a sharing of profits with the government: If no income is earned, no tax is paid; the basis used for the computation of the tax is net income. Third, the argument is advanced that the government is an equity-holder in the enterprise and thus payments thereto are distributions of profit. Yet, as sound as these arguments may appear, there are valid grounds for rejecting each of these propositions.

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<sup>9</sup>Eldon S. Hendriksen, "The Treatment of Income Taxes by the 1957 AAA Statement," The Accounting Review, XXXIII (April, 1958), 217. Similar views were expressed by F. S. Capon in a Symposium, "What are Corporate Income Taxes?" The Journal of Accountancy, LXXVIII (October, 1944), 303-304.

<sup>10</sup>David H. Li, "Income Taxes and Income Tax Allocation Under the Entity Concept," The Accounting Review, XXXVI (April, 1961), 265.

### The Income Tax Charge as a Cost

Return-on-capital-invested viewpoint. Many accountants argue that the purpose of determining net income is not so much to measure managerial efficiency as to measure the return on capital invested. They make the very valid assumption that the profit figure most meaningfully signifies "net" to those who put their money into the enterprise rather than the amount available to such persons and governmental entities, or to such persons and governmental entities and employees.<sup>11</sup>

While it may be true that for management cost control purposes the income tax should play only a nominal role, for general all-purpose reporting to outside parties "net available to stockholders" is the most significant figure. Clearly, then, the income tax charge should be shown as a deduction in the income statement as a cost rather than as a direct charge to retained earnings like dividends. Such a position is consistent with and reinforced by the basic entity concept of accounting as expounded by Gilman. He asserts that under the entity concept, profit is an increase in the amount the accounting entity owes to the proprietor, disregarding advances and withdrawals.<sup>12</sup>

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<sup>11</sup>William A. Paton in a letter to Greer on June 30, 1945, "Placement of Taxes in Income Statement," The Accounting Review, XXI (January, 1946), 86.

<sup>12</sup>Stephen Gilman, Accounting Concepts of Profits (New York: The Ronald Press Company, 1939), p. 48.

It follows, then, that income taxes must be deducted as a cost in order to determine the increase in the amount owed to stockholders.

Form not controlling. The second proposition--that the tax is computed on the basis of income and is therefore a distribution thereof--is also on questionable ground. The basis used for the computation of the tax should not be the controlling factor in deciding the nature of the tax charge. Governmental entities resort to a variety of methods to support their activities. Upon considering other types of taxes, for example the property tax, there seems to be almost no relation between the payment and any service rendered by the government. Some government revenues are raised by taxes on property and other portions are obtained by taxes on income.<sup>13</sup> Just as there is little question that the former is a cost so should there be little doubt concerning the latter--the method of measurement notwithstanding.

The government-as-partner viewpoint rejected. The proposition that the government is a partner or equity-holder in the enterprise, and therefore, payments thereto are distributions of income, is also rejected. The refutation of this proposition rests upon the fact that no investment either in services or goods (capital) has been made by the government as in the case of stockholders. It is true that the government has a claim to the assets of an enterprise once a tax liability has been established. But this claim has the nature of the

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<sup>13</sup>William A. Paton in a letter to Greer on July 13, 1945, "Placement of Taxes in Income Statement," The Accounting Review, XXI (January, 1946), 88.



claims of creditors,<sup>14</sup> not owners. The "offset" giving rise to the claims of creditors appears at some point in time as a revenue deduction and not as an income distribution. For example, take accounts payable, the most common liability. Usually, this claim results from the contribution of goods to the enterprise and when sold are subtracted from the resulting revenue. Clearly, the creditors are not considered "partners" or equity-holders. Thus, the payment to satisfy the tax claim is not one of a distribution to equity-holders, but rather one of having the character of a revenue deduction.

Additional rejections. There have been advanced several additional reasons why the corporate income tax charge is a cost and not a sharing of profits. Justice Day, in delivering the opinion of the court upholding the constitutionality of the Corporate Tax Law of 1909 stated:

It (the income tax) is a tax upon the doing of business with the advantages which inhere in the peculiarities of corporate or joint stock organizations . . . In other words, the tax is imposed upon the doing of business of the character described, and the measure of the tax is to be the income . . . the requirement to pay such taxes involves the exercise of privileges, and the element of absolute and unavoidable demand is lacking. If business is not done in the manner prescribed in the statute, no tax is payable.<sup>15</sup>

This opinion emphasized that the tax is imposed upon a corporation (1) for the privilege of doing business as a corporation and (2) it is a separate entity. The first point indicates that, as George O. May

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<sup>14</sup>Thomas F. Keller, "The Annual Income Tax Accrual," The Journal of Accountancy, CXIV (October, 1962), 62.

<sup>15</sup>Flint v. Stone Tracy Co., 220 U. S. 107 (1911)

pointed out, the income tax charge is an excise tax for the privilege of carrying on business as a corporation, and as such it is a part of the cost of doing business.<sup>16</sup>

The second point emphasized by the court reinforces the entity concept. That is, the income tax is a levy on the enterprise as a separate accounting entity apart from the owners. Consequently, it is a tax that must be paid by the corporation and must be met before any distributions are made to the stockholders.<sup>17</sup> Clearly, under the entity concept, the purpose of income determination is to measure the earnings of the enterprise which may become available for distribution to the owners. Thus, from the entity viewpoint--the basis of financial reporting--income taxes are a deduction from revenue.

Stephen Gilman offers a different view as to why the annual income tax charge should be an expense. He maintains that inasmuch as no future benefit is derived from paying taxes the only possible motive for making such an expenditure is to receive protection against some threat to future profits--the threat, of course being governmental retribution. Thus, taxes are like insurance premiums serving

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<sup>16</sup>George O. May, Twenty-Five Years of Accounting Responsibility (Vol. II, ed. Bishop C. Hunt. 2 vols.; New York: American Institute Publishing Co., Inc., 1936), p. 41.

<sup>17</sup>For a discussion of the key historic court cases which have considered the question of whether or not the corporate income tax is a cost, see Edward McCarthy, "When Does a Tax Accrue?" The Journal of Accountancy, XXXVII (April, 1924), 268-274; James E. Lamb, "Are Income Taxes an Operating Expense?" The Certified Public Accountant, IV (May, 1925), 198-199; and for a Canadian viewpoint, H. D. Clapperton, "Is Income Tax a Deduction From Income?" The Canadian Chartered Accountant, XXII (April, 1933), 674-680.

to protect against tax penalties and serious troubles which may have a direct relationship to future profits.<sup>18</sup> In this sense, then, taxes are an expense.

In brief, each of the arguments advanced for considering the corporate income tax charge as a distribution of profits rather than as a cost of doing business does not stand up under close examination. The only conclusion which is consistent with existing accounting theory holds that the annual corporate income tax charge is a cost.

#### B. THE ECONOMIC NATURE OF THE CORPORATE INCOME TAX

While accounting theory indicates the proper treatment of the annual tax charge is a deduction from revenue in the income statement, the problem presents itself of the adjustment of a "tax account" appearing on the balance sheet when the tax rate is changed such as the American economy is currently experiencing. Assume that a corporation has listed among its liabilities an account entitled Deferred Income Tax Liability;<sup>19</sup> then there is a change in the tax rates which appears to be permanent. What should be the disposition of the account? An inquiry into the economic nature, with emphasis on the shifting and incidence, of the corporate income tax may shed some light on the solution to this dilemma currently facing most business enterprises.

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<sup>18</sup>Gilman, op. cit., pp. 314-315.

<sup>19</sup>For an analysis for how this account and its counterpart, Deferred Income Tax Expense, might arise and their exact accounting nature, see infra, Chapter IV.

To state the problem differently, when corporate income tax rates are reduced, if the firm passes the reduction on to its customers via reduced prices or to its employees via higher wages, then the income tax has the nature of other costs--at least in the long run. If, however, prices and/or wages remain unchanged in the face of a corporate tax rate change, ceteris paribus, the stockholder bears the burden; future revenue streams are thus unaffected.

### The Nature of the Tax

As a true cost. Like accountants, economists express disagreement over whether the corporate income tax is a true cost. Some economists, again like some accountants, maintain that the actual liability only arises after profits are realized. In essence, they maintain that the tax is collected after the decisions on prices and production have been made. It follows, then, that corporate income taxes are unlike other costs in that they do not affect prices and output.<sup>20</sup> By the process of elimination the income tax charge is not an expense.

Economists also contend that the income tax is not a true cost primarily because it cannot be anticipated. Yet they quite readily demonstrate the maximizing of profits by the businessman in terms of expected marginal cost and marginal revenue analysis. If a firm can anticipate the marginal cost and marginal revenue schedules it will be faced with, then by simple addition total revenue and total costs

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<sup>20</sup>Richard Goode, The Corporation Income Tax (New York: John Wiley and Sons, 1951), p. 50. See also Robert S. Ford, "Some Economic Aspects of the Present Corporate Income Tax," 1947 Proceedings, National Tax Association (Sacramento: National Tax Association, 1947), pp. 56-57.

schedules can be derived. Of course, with a given tax rate, the amount of the tax liability can be estimated as the tax rate is applied, at least in the theoretical world of the economists, to the difference in total revenue and total costs. Thus, it would be inconsistent to conclude in one breath that the corporate income tax is not a cost because it is not known until the end of the period, and in the next breath suggest that firms maximize profits by producing an amount which reflects their exact anticipations in terms of marginal cost and marginal revenue. The argument that the corporate income tax is not a true cost because it can not be anticipated is inconsistent with present-day economic analysis.<sup>21</sup>

The tax base. Economics and accounting employ different concepts of profits. In measuring profit, accountants usually deduct from revenue only those costs involving actual contractual obligations--objective, explicit costs. Economists, however, consider not only the accountants' explicit costs, but also certain implicit or opportunity costs--the cost of by-passing the available alternatives. Quantitatively, the most important item of implicit costs is the interest which could be received by the stockholders of the firm if their funds were invested elsewhere.

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<sup>21</sup>James M. Murray, "A Criticism of the Traditional View of the Incidence of the Corporate Income Tax," Western Business Review, V (February, 1961), 23. See also D. H. Robertson, "The Colwyn Committee, The Income Tax and the Price Level," The Economic Journal, XXXVII (December, 1927), 581.

Economic analysis assumes that firms must cover both accounting and implicit costs in the long run. If this were not the case, stockholders would switch their investments to the alternatives heretofore by-passed. Accordingly, the economist's typical average cost curve includes both explicit and implicit costs. Since implicit costs are not deductible in determining taxable income, the conclusion is reached that the base of the corporate tax is accounting rather than economic profits.<sup>22</sup>

#### The Shifting and Incidence of the Tax

The business upon which the government originally levies a tax and which likewise originally pays the tax, based upon accounting profits, may not be the one which bears the burden in the last instance. The process of the transfer of a tax is generally known as the "shifting" of the tax, while the settlement of the burden on the ultimate taxpayer is referred to as the "incidence" of the tax. The incidence of the tax results from the shifting.<sup>23</sup>

Short run. Both traditional and contemporary economists generally hold that the corporate income tax is not shifted in the short

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<sup>22</sup>Ibid., p. 24. See also, J. Fred Weston, "Incidence and Effects of the Corporate Income Tax," National Tax Journal, II (December, 1949), 302-307.

<sup>23</sup>Edwin R. A. Seligman, The Shifting and Incidence of Taxation (New York: Columbia University Press, 1927), p. 1. The introduction of this book is reprinted in Richard A. Musgrave and Carl S. Shoup (eds.), Readings in the Economics of Taxation (Homewood, Illinois: Richard D. Irwin, Inc., 1959), pp. 202-213.

run.<sup>24</sup> Goode maintains that this proposition holds true regardless of the degree of competition or monopoly.<sup>25</sup> Shoup, however, points out that such a generalization must be qualified by specifying a tax change of something less than extreme magnitude.<sup>26</sup>

A graphic presentation of an analysis of the effects of a change in the corporate income tax rate is presented in Exhibit 1. The market situation used is that of perfect competition. The solid lines represent the position of the firm before an increase in tax rates is instituted. The firm is maximizing profits by producing at point T where marginal costs (MC) equals marginal revenue (MR) or price (P). Output is also at the low point of the average total economic costs (ATEC) curve. Marginal cost (MC) equals ATEC at point T. At point X, MC equals average total accounting costs (ATAC). The difference

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<sup>24</sup>"While no unanimity of opinion exists on this score (that the corporation income tax rests on profits) the view that the tax is not shifted, particularly in the short run, is still most widely held." Daniel M. Holland, "The Differential Tax Burden on Stockholders," The American Economic Review, XLV (Proceedings, May, 1955), 416. See also, Richard Goode, "The Corporate Income Tax and the Price Level," The American Economic Review, XXXV (March, 1945), 40-58; Sub-Committee on Federal Corporate Net Income Tax, The National Tax Association, "Economic Effects of the Corporation Income Tax," 1949 Proceedings, National Tax Association (Sacramento: National Tax Association, 1950), pp. 458-470; and Committee on Federal Corporate Net Income Tax, The National Tax Association, "Final Report of the Committee on the Federal Corporate Net Income Tax," 1950 Proceedings, National Tax Association (Sacramento: National Tax Association, 1951), pp. 54-73.

<sup>25</sup>Richard Goode, "The Corporate Income Tax and the Price Level," The American Economic Review, XXXV (March, 1945), 48.

<sup>26</sup>Carl Shoup, "Incidence of the Corporation Income Tax: Capital Structure and Turnover Rates," National Tax Journal, I (March, 1948), 12-13.

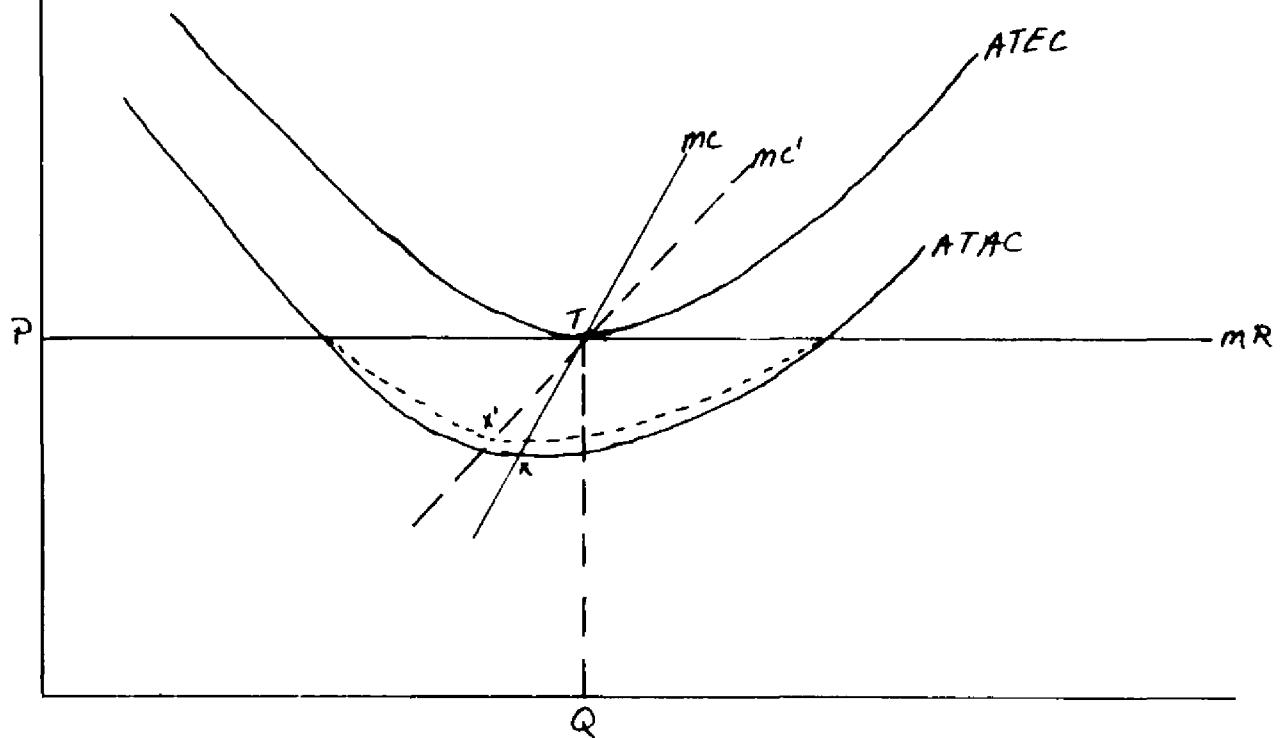


EXHIBIT 1  
SHORT RUN EFFECTS OF A CHANGE  
IN INCOME TAX RATES

between ATEC and ATAC represents implicit opportunity costs. The broken lines represent the immediate effect of an increase in the tax rate, say from 40 per cent to 50 per cent. Since implicit costs are not allowable deductions for tax purposes, the tax will take about one-tenth more of the firm's accounting profits, or one-tenth of the difference between the revenue (P) and accounting costs (ATAC) at all levels of output. While the shape of the MC line changes to MC', it still passes through the price line at the same point (T) as it did before the tax rate change. Such an economic analysis concludes that a change in corporate



income tax rates does not result in a change in the price for a firm which is maximizing profits in the short run.<sup>27</sup> And of extreme importance, empirical evidence does not disprove this conclusion.<sup>28</sup>

Such a conclusion, however, must be tempered by specifying a rather small tax change. For instance suppose the corporate income tax rate was increased from 40 per cent to 80 per cent and the new rate was expected to remain in force indefinitely. Intuitively, it seems unlikely that the firms in our economy would keep the prices of their products unchanged in the wake of such drastic cuts in profits available to the stockholders. The result would probably be immediate increases in prices of their products by all firms. Thus, with an extremely large increase in the tax rate, probably its burden would be shifted in the short run.

Long run. Unlike tax shifting in the short run, economists seem to be divided over the question whether the corporate income tax is shifted in the long run. Generally, the economists who have written on this subject can be divided into three groups: (1) those who apparently feel that none, or at least very little, of the tax is

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<sup>27</sup>This analysis is adopted, with modification, from Murray, op. cit., p. 24. A slightly different analysis but with the same basic conclusions as outlined here is presented in Weston, op. cit., pp. 306-310.

<sup>28</sup>Eugene M. Lerner and Eldon S. Hendriksen, "Federal Taxes on Corporate Income and the Rate of Return on Investment in Manufacturing, 1927-1952," National Tax Journal, IX (September, 1956), 195-199.

shifted; (2) those who believe that varying, and usually indeterminate, amounts of the tax are shifted; and (3) those who believe that all, or at least most, of the tax is shifted.

Perhaps as much or even more than any other economist, M. A. Adelman exemplifies the first group, i.e., those who conclude that corporate income tax shifting is either nonexistent or insignificant. He examined corporate profits before taxes as a fraction of all income originating in U. S. corporate enterprises for the 1920's and for the period 1946-55 and found it almost identical for the two periods. Adelman concluded that the higher tax rate of the second period was not recovered via lower wages or higher prices; that is, the tax was not shifted.<sup>29</sup>

Several recent writers belong in the second category. Musgrave, for example, suggests that about 45½ per cent of the corporation income tax is shifted forward to consumers and one-eighth backward to employees.<sup>30</sup> While not being as precise in their estimates of the

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<sup>29</sup>M. A. Adelman, "The Corporate Income Tax in the Long Run," The Journal of Political Economy, LXVC (April, 1957), 151-157.

<sup>30</sup>A. Musgrave, J. J. Carroll, L. D. Cook, and L. Frane, "Distribution of Tax Payments by Income Groups: A Case Study for 1948," National Tax Journal, IV (March, 1951), 16.

degree of tax shifting, Somers,<sup>31</sup> Shoup,<sup>32</sup> and Colm,<sup>33</sup> among others, also believe that the entire tax burden is not borne in the long run by the stockholders.

The third school of thought--that the corporate income tax is shifted significantly--seems to appeal to as many economists as are in the first two groups combined. And many economists believe that this is the prevailing opinion. They point to recent empirical studies which, while not proving that the tax is not shifted, at least are consistent with this view. Lerner and Hendriksen<sup>34</sup> in examining the effects of changes in the tax rate on the return on investment in manufacturing between 1927 and 1952 found that in the long run the level of taxation has had no discernible effect on the rate of return on investment. Thus, they conclude that the tax was shifted. Clendenin, in a similar study, arrived at the same conclusion.<sup>35</sup> Other

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<sup>31</sup>Harold M. Somers, Public Finance and National Income (Philadelphia: The Blakiston Company, 1949), p. 216.

<sup>32</sup>Carl S. Shoup, "Some Considerations on the Incidence of the Corporation Income Tax," The Journal of Finance, VI (June, 1951), 187-196.

<sup>33</sup>Gerhard Colm, "The Corporation and the Corporate Income Tax in the American Economy," The American Economic Review, XLIV (Proceedings, May, 1954), 486-503.

<sup>34</sup>Lerner and Hendriksen, op. cit., pp. 193-202.

<sup>35</sup>John C. Clendenin, "Effects of Corporate Income Taxes on Corporate Earnings," Taxes--The Tax Magazine, XXXIV (June, 1956), 396.

writers hold similar conclusions, although there is a great deal of diversity of opinion over the form of the shifting.<sup>36</sup>

Again using a priori reasoning, it seems unlikely that the corporate income tax permanently reduces the return to the stockholders. Otherwise, the United States would have experienced a general withdrawal of capital from the investment or capital sector of the economy and a reinvestment in other areas. The opposite tendency is clearly obvious. However, it is not known what the effects would have been if the tax rate had remained unchanged. And it is possible that increased tax rates have spurred an increase in production efficiency to offset the increasing tax burden.

In brief, the majority of economists, at least recent writers on the subject, believe that the corporate income tax is not shifted in the short run. While over the long run, there is divided opinion as to whether the tax is shifted, the majority opinion seems to hold that the tax is significantly shifted. The manner and degree of shifting in the long run, however, seems to depend upon the attendant circumstances.

Accounting implications of tax shifting. As indicated earlier, accountants frequently set up on the balance sheet income tax related accounts which are to be written off over a series of future accounting

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<sup>36</sup>Don M. Soule, "Shifting of the Corporate Income Tax: A Dynamic Analysis," The Journal of Finance, XIV (September, 1959), 390-402; Arnold C. Harberger, "The Incidence of the Corporation Income Tax," The Journal of Political Economy, LXX (June, 1962), 215-240. See also Morris Beck, "Ability to Shift the Corporate Tax: Seven Industrial Groups," National Tax Journal, III (September, 1950), 248-256.

periods. The amount to be periodically added to the balance sheet tax account is based upon the prevailing tax rates. The increases to the Deferred Income Tax Liability account often result from accelerated depreciation methods allowed for tax purposes but not used in financial reporting.

To illustrate, suppose that a firm purchases a capital asset (in economic terminology), say a piece of machinery, and takes advantage of the accelerated depreciation provisions of the tax law, e.g. double declining balance, but uses straight-line depreciation for accounting and reporting purposes. In the early years of ownership of the asset, depreciation is greater for tax purposes than for reporting purposes and in the later years the reverse is true. Thus, in the early years, the amount of tax liability is greater than in the later years, ceteris paribus. To "correct" this situation some accountants favor reporting on the income statement tax expense based upon the accounting depreciation and charge the difference between the accounting income tax expense and the actual tax liability--the former being greater in the early years--to a balance sheet account such as Deferred Income Tax Liability. Then in the last years of the asset's life, the accounting tax expense would be less than the actual tax liability. Therefore, the balance sheet tax account would be reduced, according to the majority of accountants, to zero. This procedure is known as interperiod tax allocation.

In such a procedure, up until recently, accountants have safely ignored the possibility of corporate income tax rate changes.<sup>37</sup> The 1964 Revenue Act, reducing the corporate income tax rate, has shattered such an illusion. In light of these developments, accountants must now seek to re-examine the balance sheet income tax account. Perhaps the evidence concerning the shifting of the corporate income tax sheds some light on a possible avenue of approach to the dilemma created by recent tax rate changes.

Economists define the short run as a period long enough for output, but not plant, to vary.<sup>38</sup> In accounting terms, this period generally means before the fixed assets are replaced. It will be recalled that the preceding analysis concluded that the corporate income tax was not shifted in the short run unless the rate was changed by an extreme amount. As the 1964 tax rates were decreased 2 per cent from the 1963 level and another 2 per cent decrease is effective for 1965, it is concluded, therefore, that this decrease is not being passed on to the

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<sup>37</sup>Interperiod tax allocation first received mention in the latter years of World War II when certificates of necessity were being issued. After the War and up until 1964, no change had taken place in the corporate income tax rate structure. In determining his estimates of the amount to be added to (or deducted from) the balance sheet income tax account, the accountant was admonished to use the "rate in effect during the period covered by the income statement . . ." American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," Accounting Research Bulletin No. 43 (New York: American Institute of Accountants, 1953), p. 89, reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

<sup>38</sup>E. Cary Brown, "The Corporate Income Tax in the Short Run," National Tax Journal, VII (September, 1954), 241.

consumer via lower prices or alternatively, to the employees via higher wages. That is, the revenue stream of the firm will, ceteris paribus, remain the same while the matching costs, at least in the form of income taxes, have been decreased. Such a situation, then, clearly calls for an adjustment of the balance sheet tax account. The technique of such an adjustment is demonstrated in the next chapter.

In the long run, by definition, the asset which gives rise to a "long term" balance sheet tax account is replaced. Accordingly, the corresponding tax accounting begins anew and no adjustment in the tax account is needed other than at the time the tax rate changes. Put differently, for accounting purposes here, the "long run" is a series of "short runs." If the short run adjustments are properly accounted for, then no long run adjustment is necessary for financial reporting purposes.

#### C. THE LOCATION OF THE INCOME TAX CHARGE IN THE INCOME STATEMENT

The above analysis concludes that the periodic corporate income tax charge is properly considered as a cost of doing business. It is a revenue deduction properly reflected in the income statement in accordance with the basic accounting concept of matching.

##### Placement of the Current Charge on Normal Operations

As a separate item. Different viewpoints have been expressed as to the location of the income tax charge in the income statement. The so-called historical position features striking a balance after all

deductions except the federal income tax charge and calling this balance Net Income Before Income Taxes. Then the federal income tax charge is listed and deducted as a separate item in arriving at net income.<sup>39</sup> Of 540 companies examined by the American Institute of Certified Public Accountants which reflected estimated federal income taxes in their income statements, 385 presented such estimates as a separate last item.<sup>40</sup> The condensed income statement of Exhibit 2 serves as an example of this method of income tax reporting.

## EXHIBIT 2

### United Fruit Company and Subsidiaries<sup>41</sup> Statement of Consolidated Earnings For the Year Ended December 31, 1963

Income from operations. . . . .	\$ 11,021
Interest and other income . . . . .	<u>2,422,277</u>
Net income before taxes . . . . .	\$2,433,298
Provision for United States and foreign income taxes . . . . .	<u>1,975,000</u>
Net earnings . . . . .	<u>\$ 458,298</u>

Reporting the income taxes as a last separate deduction seems to stress the extent of the government's participation in the business profits which would otherwise presumably be available, at least in

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<sup>39</sup>Norman J. Lenhart and Philip L. Defliese, Montgomery's Auditing (eighth edition; New York: The Ronald Press Company, 1957), p. 110.

<sup>40</sup>American Institute of Certified Public Accountants, Accounting Trends & Techniques--1963 (seventeenth edition; New York: American Institute of Certified Public Accountants, 1963), p. 181.

<sup>41</sup>United Fruit Company, Annual Report, 1963, p. 9.



the short run, to the stockholders. Furthermore, such a technique stresses the performance of management in operating the business by striking a balance before income taxes. Income taxes are generally considered to be beyond the control of management. These two points, it will be recalled, are at the heart of the rationale for not considering the income tax charge as an expense.

Classified with other costs. In order to stress the "cost" aspect of income taxes, for it is a cost, Paton suggested placing the annual income tax charge immediately following expenses and related charges but before the computation of any net income figure.<sup>42</sup> Out of 540 companies surveyed by the American Institute of Certified Public Accountants which reflected an income tax charge in their 1962 income statements, 155 reported this expense along with other costs.<sup>43</sup> The condensed income statement of Exhibit 3 reflects the classification of federal income taxes along with other expenses.

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<sup>42</sup>William A. Paton, "Adaptation of the Income Statement to Present Conditions," The Journal of Accountancy, LXXV (January, 1943), 13.

<sup>43</sup>American Institute of Certified Public Accountants, Accounting Trends & Techniques--1963, loc. cit.

## EXHIBIT 3

General Mills, Inc. and Its Consolidated Subsidiaries<sup>44</sup>  
 Results of Operations  
 For the Year Ended May 31, 1963

SALE OF PRODUCTS AND SERVICES	<u>\$532,946,004</u>
COSTS:	
Cost of products and services sold, exclusive of items shown below . . . . .	\$373,886,503
Depreciation . . . . .	7,324,406
Interest . . . . .	2,258,307
Contributions to employees' retirement plan . . . . .	2,321,337
Profit sharing distribution . . . . .	1,032,300
Selling, general and administrative expenses . . . . .	108,145,955
Federal taxes on income . . . . .	<u>14,065,000</u>
Total costs	<u>\$509,033,808</u>
EARNINGS FOR THE YEAR . . . . .	<u><u>\$ 14,912,196</u></u>

A more recent writer, H. W. Kull, also wrote against featuring income taxes as the last and separate deduction from income, but on different grounds than that of Paton. Kull felt that showing the income tax as a separate deduction seems to invite undue attention to this one type of tax; thus, the idea is strengthened that the income tax is government's principal means of sharing in corporate profits. He would like to show the government's "total take" in the distribution of corporate gross revenues, including excise and property taxes, by lumping all taxes together and showing as the result a deduction along with other costs.<sup>45</sup> This procedure is illustrated in Exhibit 4.

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<sup>44</sup>General Mills, Annual Report, 1963, p. 10.

<sup>45</sup>H. W. Kull, "Reporting of Taxes in Annual Reports," The Controller, XXVII (November, 1959), 506.

## EXHIBIT 4

The Standard Oil Company and Subsidiaries<sup>46</sup>  
 Consolidated Income Statement  
 For Year Ended December 31, 1963

TOTAL INCOME . . . . .	<u>\$507,098,869</u>
COSTS AND EXPENSES . . . . .	
Materials, merchandise, operating and other expenses . . . . .	\$324,678,652
Salaries, wages, and employees' benefits . . . . .	80,697,896
Taxes and other payments to governments . . . . .	33,785,575
Depreciation of facilities . . . . .	19,638,861
Depletion of oil and gas producing properties . . . . .	5,333,435
Nonproductive wells and surrendered mineral leases . . . . .	7,474,306
Debenture and other interest . . . . .	<u>1,603,527</u>
	<u>\$473,212,252</u>
NET INCOME . . . . .	<u>\$ 33,886,617</u>

Intraperiod Tax Allocation

Allocation procedures. Frequently, both normal and extraordinary transactions enter into the calculation of the income taxes. Where the extraordinary items are of a material amount, Accounting Research Bulletin No. 43 recommends the allocation of the taxes between income from normal operations and the extraordinary items. Thus, the amount deducted in the income statement as Federal Income Tax Expense should be the amount which would have been accrued without the special items.<sup>47</sup> The amount of taxes assignable to extraordinary items is the difference between the full amount of the taxes accrued and the amount

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<sup>46</sup>The Standard Oil Company (An Ohio Corporation), Annual Report, 1963, p. 22.

<sup>47</sup>American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," op. cit., pp. 88-89.

related to normal transactions.<sup>48</sup> As this procedure allocates within the period the total amount of income taxes estimated to be payable for the period, it is referred to as intraperiod income tax allocation.

In assigning the tax related to extraordinary items, it does not seem feasible or even that any advantage would be gained by determining the tax effect attributable to every separate extraordinary item. It has been pointed out, however, that "the allocation of the tax provision is made on the assumption that the extraordinary item is assigned to the highest tax bracket."<sup>49</sup> But yet, if there were two or more extraordinary items involved, a pro-rata allocation may be more appropriate than the procedures recommended by the Committee.<sup>50</sup>

When the form of the income statement is used which reports extraordinary transactions after the normal and recurring items, the all-inclusive income statement, the tax allocation as outlined here affects only sections on the income statement. If on the other hand, unusual nonrecurring items are reported in the statement of retained earnings, the current operating performance income statement resulting,

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<sup>48</sup>The disclosure of the effect on income taxes of an unusual item of revenue or expense, whenever the effect is material, is also supported by the AAA. See American Accounting Association, Executive Committee, "Accounting Concepts and Standards Underlying Corporate Financial Statements--1948 Revision," Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus, Ohio: American Accounting Association, 1957), p. 17.

<sup>49</sup>New Jersey Society of Certified Public Accountants Committee on Accounting Principles and Practice, "Comment on 'Accounting for Income Taxes,'" The Journal of Accountancy, LXXIX (March, 1945), 238.

<sup>50</sup>Ibid., p. 239.

then tax allocation affects both the income statement and statement of retained earnings as the tax effects should follow the extraordinary items. In either case, most accountants recommend reporting on the income statement the actual amount of the income taxes for the period together with the amount of the adjustment relating to the special extraordinary items.<sup>51</sup>

Use of footnotes. An alternative to the procedure of reflecting the amount of the tax allocation within the statements is to deal with the tax situation in footnotes. As George O. May pointed out, however, while such an alternative may be adequate for the investment analyst, it may be inadequate for the small investor who is likely to rely on summaries of financial statements in which footnotes are not reflected. The statement presentation would be far more illuminating than a technical footnote explanation to such a user of financial reports.<sup>52</sup>

Illustrations of intraperiod tax allocation. Table I reflects the method used for reporting the intraperiod allocation of income taxes by 124 firms which experienced extraordinary transactions during 1962. All but ten reflected the amount of the tax effect of the extraordinary item within the statements. Five chose footnotes as an alternative and five relegated such information to the stockholders' letter.

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<sup>51</sup>Robert L. Carr, "Allocation of Federal Income Tax--Review and Explanation," N. A. A. Bulletin, XLIV (December, 1962), 6.

<sup>52</sup>George O. May, "Income Taxes and Intangibles: Two Significant Research Bulletins," The Journal of Accountancy, LXXIX (February, 1945), 126.

TABLE I  
ALLOCATION OF CURRENT INCOME TAXES--1962  
Presentation in Reports

	<u>With Tax Estimate</u>	<u>With Special Item</u>	<u>In Foot- notes</u>	<u>In Letter to Stock- holders</u>	<u>Total</u>	<u>B: Retained Earnings</u>	<u>1962 Total Items</u>
Extraordinary items shown net of related tax	-	28	2	3	33	39	72
Extraordinary items shown in full amount	-	36	3	2	41	6	47
Only tax effect of extraordinary items shown	2	-	-	-	2	3	5
Total	<u>2</u>	<u>64</u>	<u>5</u>	<u>5</u>	<u>76</u>	<u>48</u>	<u>124</u>

SOURCE: American Institute of Certified Public Accountants, Accounting Trends & Techniques--1963 (seventeenth edition; New York: American Institute of Certified Public Accountants; 1963), p. 181.

The condensed income statement and statement of retained earnings in Exhibit 5 exemplifies intraperiod tax allocation within the period but between statements.

# EXHIBIT 5

## Gulf States Utilities Company<sup>53</sup> Income Statement For the Year Ended December 31, 1963

TOTAL OPERATION REVENUES. . . . .	\$110,779,054
OPERATING EXPENSES AND TAXES:	
Operation . . . . .	\$ 36,916,892
Maintenance . . . . .	6,017,698
Depreciation . . . . .	14,718,550
Taxes--Federal income (excluding \$415,367 charged to retained earnings). . . . .	13,122,256
Taxes--Deferred Federal income--net. . . . .	2,911,723
Taxes--Other . . . . .	8,445,819
Total. . . . .	\$ 82,132,938
NET OPERATION REVENUES . . . . .	28,646,116
OTHER INCOME . . . . .	88,407
GROSS INCOME . . . . .	\$ 28,734,523
DEDUCTIONS FROM INCOME . . . . .	9,157,932
NET INCOME. . . . .	\$ 19,576,591

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<sup>53</sup>Gulf States Utilities, Annual Report, 1963, p. 18.

## EXHIBIT 6

Gulf States Utilities Company<sup>54</sup>  
Statement of Retained Earnings  
For the Year Ended December 31, 1963

BALANCE JANUARY 1 . . . . .	\$49,485,836
ADDITIONS	
Net income . . . . .	19,576,591
Gain on sale of properties, less related	
Federal income taxes of \$415,367 . . . . .	<u>1,206,801</u>
Total . . . . .	<u>\$70,269,228</u>
DEDUCTIONS	
Preferred dividends . . . . .	\$ 2,473,756
Common dividends . . . . .	<u>11,618,504</u>
Total . . . . .	<u>14,092,260</u>
BALANCE DECEMBER 31 . . . . .	<u><u>\$56,176,968</u></u>

The rationale of intraperiod tax allocation. The objective of intraperiod tax allocation is to associate the tax effects with the unusual items causing the tax to be different from that computed on normal operations. The rationale of such allocation procedures seems to center around providing a net income from normal activities which is neither inflated by a tax benefit nor deflated by a tax penalty as a result of extraordinary items. Thus, it is generally conceded that "Net Income After Taxes"--taxes on recurring activities--is both a more meaningful balance and a balance that enhances the comparability with similar figures of prior periods and with other similar companies.<sup>55</sup>

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<sup>54</sup>Ibid., p. 19.

<sup>55</sup>Ronald J. Patten, "Intraperiod Income Tax Allocation--A Practical Concept," The Accounting Review, XXXIX (October, 1964), 879.



In this manner, intraperiod tax allocation increases the utilitarian value of the income statement which is the purpose of financial reporting in the first place.

#### IV. SUMMARY

An inquiry into the accounting and economic nature of the corporate income tax charge points to the appropriate treatment of such charges for financial reporting purposes.

Two viewpoints have been expressed by accountants as to the nature of the income tax charge. One position holds that the corporate tax charge is a distribution of profit. The opposing viewpoint holds that income taxes are an expense. A careful analysis of the arguments which are presented in support of both positions reveals that the only conclusion consistent with existing accounting theory holds that the annual corporate income tax charge is a cost to the business and should be treated as a revenue deduction.

Likewise, an examination of the economic nature of the corporate income tax charge reveals that the only position which is consistent with contemporary economic analysis holds that the income tax charge is a business cost. The tax base is, however, "accounting" profits rather than "economic" profits. Economists generally hold that the corporate income tax is not shifted in the short run, meaning that the stockholders must bear the burden of higher taxes or enjoy the rewards of lower rates. On the other hand, while there is some difference of opinion, many economists do hold that the corporate income tax is

shifted in the long run. These conclusions imply that any balance sheet tax account--one that is accumulated over several accounting periods--should be adjusted whenever the corporate tax rate changes.

Since an examination of the accounting and economic nature of the corporate income tax reveals that it is a cost, then it follows that such a charge should be reflected as a revenue deduction in determining the net income figure on the income statement. Even here there is a diversion of opinion as to whether the income tax charge should be shown as a separate and last deduction or should be simply included in the list of other costs. The latter alternative seems to be receiving more attention in recent annual reports.

While disagreeing on many other issues, accountants almost without exception favor intraperiod tax allocation. That is, the reported net income figure should only bear the burden of the current income tax charge related to normal activities and any taxes or reduction in taxes attributable to extraordinary items should be assigned thereto. Intraperiod tax allocation often arises when book income and tax return income are different because of special treatment of certain transactions for tax purposes which is quite different from that accorded the same transactions for financial reporting.

A second major factor giving rise to differences between book income and tax return income results from the timing of revenue and expense recognition. Accounting for differences in timing results in interperiod tax allocation, the subject of the next chapter.

## CHAPTER IV

### THE THEORY OF INTERPERIOD TAX ALLOCATION

As interperiod tax allocation affects the amount of reported income between years, its employment has provoked serious consideration by accountants. By the same token, probably no other single issue arising in recent accounting discussions has aroused as great of a controversy, if the writings on the subject can be taken as any indication, as has the proper accounting for differences in the timing of charges to income for income taxes. This concern of the accounting profession is justified because of the substantial impact of interperiod tax allocation on reported financial results.

On the one hand, regardless of whether or not income taxes are allocated between accounts of the same accounting period--interperiod tax allocation--the balance of retained earnings is the same. On the other hand, with interperiod tax allocation both the amount of net income for the period as well as the balance of retained earnings at the end of a given accounting period are changed.

#### A. THE NATURE OF THE PROBLEM

Situations giving rise to differences in timing and hence consideration of interperiod tax allocation, are numerous and prevade many

areas of accounting practice. There are many situations which may cause the taxable income to exceed initially the accounting income and also several cases of where the accounting income initially exceeds the taxable income.

#### When Taxable Income Exceeds Accounting Income

There are two classes of circumstances which cause taxable income to exceed accounting income in a given fiscal period. First, revenue may be deferred for financial reporting purposes but be currently recognized for tax purposes. For example, in certain instances the Internal Revenue requires the inclusion of prepaid revenue in the income tax return when such revenue is received despite the fact that such revenue is not earned until subsequent periods. Accrual accounting more realistically recommends holding such unearned revenue in abeyance on the balance sheet until the service or goods are rendered or delivered. At that time the revenue would be recognized on the income statement irrespective of the fact that the money was received in earlier periods.<sup>1</sup> Examples where prepaid revenue is recognized for

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<sup>1</sup>See American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," Accounting Research Bulletin No. 43 (New York: American Institute of Accountants, 1953), p. 88 reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

tax purposes in the period of receipt include rent, dancing lesson fees, automobile club dues, and guarantee contracts.<sup>2</sup>

The second class of circumstances which causes taxable income to be greater than accounting income is where the accounting deductions of a given period exceed the corresponding deductions for tax purposes. Accounting for warranty expenses exemplifies this situation. Accrual accounting recognizes as a deduction an estimated amount of expenses of future periods before the actual expense is incurred. On the other hand, tax accounting only allows a deduction for warranty expenses when the expense is actually incurred. Thus, usually warranty expense deductions are recognized in the financial statements in advance of their appearance on the tax return.

A similar case arises in the amortization of initial organization costs for accounting purposes in a time period less than that allowable for tax purposes. Accounting for certain experimental and research expenditures may give rise to a similar situation.

#### When Accounting Income Exceeds Taxable Income

There are also two sets of circumstances which cause accounting income to exceed initially taxable income. First, revenue may be

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<sup>2</sup>For a discussion of some of these and other examples, including the relevant major court decisions, which have caused the tax law to fly in the face of sound accounting in the area of prepaid revenue, see Doyle Z. Williams, "The Application of the Claim of Right Doctrine to Prepaid Income," The Louisiana Certified Public Accountant, XXIII (October, 1963), 48-61.

recognized for financial accounting purposes in one period while the same revenue may be deferred to later years for tax purposes. A typical example of this situation is where a long-term construction contractor uses the percentage-of-completion method for accounting purposes<sup>3</sup> while the completed-contract method is employed for tax purposes. Another example is the recognition by some finance companies of an increase in the market value of certain securities for accounting purposes even though not recognized for tax purposes until the period of sale. One other example of this situation is when an enterprise uses the cash-basis of reporting for tax purposes and the accrual basis of accounting for financial reporting purposes where the accrued receivables exceed the accrued payables.

The second class of circumstances resulting in the accounting income being greater than the taxable income is where certain expenses are deferred for financial accounting purposes but are currently recognized for tax purposes. Examples include unamortized discount on bonds refunded charged off immediately for tax purposes but written off for financial accounting purposes over the remaining life of the retired issue,<sup>4</sup> and costs for pension plans which are deducted in

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<sup>3</sup>Recommended in American Institute of Accountants, Committee on Accounting Procedure, "Long-term Construction-type Contracts," Accounting Research Bulletin No. 45 (New York: American Institute of Accountants, 1955), p. 7 reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

<sup>4</sup>See American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," op. cit., Chapter XV.

different years for tax and reporting purposes.<sup>5</sup> The use of emergency amortization<sup>6</sup> or accelerated depreciation<sup>7</sup> of certain fixed assets for tax purposes but a slower write-off for financial accounting purposes usually causes the greatest and most common difference in financial accounting income before taxes and taxable income.

#### Illustrations of the Impact of Timing Differences on Reported Income

With all of the situations outlined above, as well as many others, which cause a difference in the timing of recognition of certain items for financial reporting purposes and tax purposes, the question of interperiod tax allocation arises. The following illustrations will serve to point up the impact of such procedures on the reported income of a firm.

Taxable income more than book income. The first illustration presents the situation which arises when taxable income initially exceeds accounting income. Assume that in January of Year I a firm receives a three year rental fee of \$60,000. For tax purposes, the entire amount

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<sup>5</sup>See John V. Pelt, "Method of Accounting for a Pension Plan," The Controller, XXI (May, 1953), 211-213, 234.

<sup>6</sup>Recommended in American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," op. cit., p. 78.

<sup>7</sup>Recommended in American Institute of Certified Public Accountants, Committee on Accounting Procedure, "Declining-balance Depreciation," Accounting Research Bulletin No. 44 (Revised) (New York: American Institute of Certified Public Accountants, 1958), pp. 1-A - 6-A reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

must be included in revenue when received. For financial accounting purposes, the \$60,000 is recognized on the income statement ratably over the three year period, or at the rate of \$20,000 per year. Assume that all other revenue during each of the three years for the firm amounts to \$120,000 per year and that expenses total \$50,000 per year. Further, assume an income tax rate of 22 per cent on the first \$25,000 of taxable income and 48 per cent on all taxable income in excess of \$25,000.

Section A of Table II indicates that \$55,900, \$27,100 and \$27,100 of income taxes would be payable to the Internal Revenue Service in Years I, II, and III, respectively. Section B of Table II illustrates the amount of net income that would be reported on the income statement if income taxes were not allocated; that is, if the amount of taxes reported on the income statement was the amount per tax return of each respective period. Section C reveals the amount of the reported income if income taxes were allocated between periods. Under income tax allocation, the amount of the income tax expense reported on the income statement is based upon the reported income before income taxes of the respective years (line 18).

If taxes were allocated, then, in Year I \$55,900 in income taxes would actually be due for the current period while only \$36,700 would be reflected in the income statement. Therefore, the difference of \$19,200 would be charged to an account like Deferred Income Tax Expense as shown in Section D of Table II. For Years II and III, the amount of taxes paid would be only \$27,100 while the amount of taxes



TABLE II

ALLOCATION OF INCOME TAXES BETWEEN PERIODS--  
TAXABLE INCOME INITIALLY EXCEEDS ACCOUNTING INCOME

Line No.		Year I	Year II	Year III	Total
A. Taxes Per Tax Return					
1	Rental revenue	\$ 60,000	- 0 -	- 0 -	\$ 60,000
2	Other revenue	<u>120,000</u>	<u>\$120,000</u>	<u>\$120,000</u>	<u>360,000</u>
3	Total revenue	180,000	120,000	120,000	420,000
4	Less expenses	<u>50,000</u>	<u>50,000</u>	<u>50,000</u>	<u>150,000</u>
5	Taxable income	<u>130,000</u>	<u>70,000</u>	<u>70,000</u>	<u>270,000</u>
6	Income taxes* (computation based on line 5)	<u>55,900</u>	<u>27,100</u>	<u>27,100</u>	<u>110,100</u>
B. Reported Income with Taxes Not Allocated					
7	Rental revenue	\$ 20,000	\$ 20,000	\$ 20,000	\$ 60,000
8	Other revenue	<u>120,000</u>	<u>120,000</u>	<u>120,000</u>	<u>360,000</u>
9	Total revenue	140,000	140,000	140,000	420,000
10	Less expenses	<u>50,000</u>	<u>50,000</u>	<u>50,000</u>	<u>150,000</u>
11	Income before income taxes	90,000	90,000	90,000	270,000
12	Less income taxes (per tax return--line 6)	<u>55,900</u>	<u>27,100</u>	<u>27,100</u>	<u>110,100</u>
13	Income after income taxes	<u>34,100</u>	<u>62,900</u>	<u>62,900</u>	<u>159,900</u>

TABLE II (Continued)

Line No.		Year I	Year II	Year III	Total
C. Reported Income with Taxes Allocated					
14	Rental revenue	\$ 20,000	\$ 20,000	\$ 20,000	\$ 60,000
15	Other revenue	<u>120,000</u>	<u>120,000</u>	<u>120,000</u>	<u>360,000</u>
16	Total revenue	140,000	140,000	140,000	420,000
17	Less expenses	<u>50,000</u>	<u>50,000</u>	<u>50,000</u>	<u>150,000</u>
18	Income before income taxes	90,000	90,000	90,000	270,000
19	Income taxes* (computation based on line 18)	<u>36,700</u>	<u>36,700</u>	<u>36,700</u>	<u>110,000</u>
20	Income after income taxes	<u><u>53,300</u></u>	<u><u>53,300</u></u>	<u><u>53,300</u></u>	<u><u>159,900</u></u>
D. Deferred Income Tax Expense Account Entries					
21	Income taxes per tax return (line 6)	\$ 55,900	\$ 27,100	\$ 27,100	\$110,100
22	Income taxes per income statement with allocation (line 19)	<u>36,700</u>	<u>36,700</u>	<u>36,700</u>	<u>110,100</u>
23	Debit (credit) deferred tax account [48% (line 1 - line 7)]	<u><u>19,200</u></u>	<u><u>( 9,600)</u></u>	<u><u>( 9,600)</u></u>	<u><u>- 0 -</u></u>

\*Tax rate: First \$25,000 of taxable income, 22%  
Above \$25,000 of taxable income, 48%

reported in the "allocated" income statement would be \$36,700 for each year. As a result, the Deferred Income Tax Expense account would be drawn down by \$9,600 in Years II and III. By comparing line 13 with line 20, which yields line 23, the impact of tax allocation on the reported income for each period is revealed.

Book income more than taxable income. The situation outlined above represents a case where taxable income in the initial period exceeded accounting income. To illustrate the reverse situation--where accounting income initially exceeds taxable income--assume that a firm has income after all expenses except depreciation and income taxes of \$100,000 per year for the period Year I through Year V, inclusive. Assume further that this firm purchases a fixed asset at the beginning of Year I for \$150,000. The asset has an estimated useful life of five years and at the end of Year V will have no salvage value. The company adopts the sum-of-the-years' digits depreciation method for income tax purposes but uses the straight-line method for financial reporting purposes.

Section A of Table III reflects the amount of taxes that must be paid each year by the firm under these conditions. In Section B, the amount of income for each year is shown assuming that the income tax expense reported on the income statement is the amount of taxes per tax return, i. e., if taxes are not allocated. The amount of income, assuming that taxes reported on the income statement are based upon income before taxes reported therein (line 12), is reflected in Section C of Table III. By comparing lines 9 and 14, the magnitude

TABLE III

ALLOCATION OF INCOME TAXES BETWEEN PERIODS--  
ACCOUNTING INCOME INITIALLY EXCEEDS TAXABLE INCOME

Line No.		Year I	Year II	Year III	Year IV	Year V	Total
A. Taxes Per Tax Return							
1	Income before depreciation and income taxes	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$500,000
2	Less depreciation (sum-of- years' digits)	<u>50,000</u>	<u>40,000</u>	<u>30,000</u>	<u>20,000</u>	<u>10,000</u>	<u>150,000</u>
3	Taxable income	<u>50,000</u>	<u>60,000</u>	<u>70,000</u>	<u>80,000</u>	<u>90,000</u>	<u>350,000</u>
4	Income taxes* (computation based on line 3)	<u>17,500</u>	<u>22,300</u>	<u>27,100</u>	<u>31,900</u>	<u>36,700</u>	<u>135,500</u>
B. Reported Income with Taxes Not Allocated							
5	Income before depreciation and income taxes	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$500,000
6	Less depreciation (straight-line)	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>150,000</u>
7	Income before <del>income</del> taxes	70,000	70,000	70,000	70,000	70,000	350,000
8	Less income taxes (per tax return--line 4)	<u>17,500</u>	<u>22,300</u>	<u>27,100</u>	<u>31,900</u>	<u>36,700</u>	<u>135,500</u>
9	Income after income taxes	<u>52,500</u>	<u>47,700</u>	<u>42,900</u>	<u>38,100</u>	<u>33,300</u>	<u>214,500</u>

TABLE III (Continued)

Line No.		Year I	Year II	Year III	Year IV	Year V	Total
C. Reported Income with Taxes Allocated							
10	Income before depreciation and income taxes	\$100,000	\$100,000	\$100,000	\$100,000	\$100,000	\$500,000
11	Less depreciation (straight-line)	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>150,000</u>
12	Income before income taxes	70,000	70,000	70,000	70,000	70,000	350,000
13	Less income taxes* (computation based on line 12)	<u>27,100</u>	<u>27,100</u>	<u>27,100</u>	<u>27,100</u>	<u>27,100</u>	<u>135,000</u>
14	Income after income taxes	<u><u>42,900</u></u>	<u><u>42,900</u></u>	<u><u>42,900</u></u>	<u><u>42,900</u></u>	<u><u>42,900</u></u>	<u><u>214,500</u></u>
D. Deferred Income Tax Liability Account Entries							
15	Income taxes per income statement with allocation (line 13)	\$ 27,100	\$ 27,100	\$ 27,100	\$ 27,100	\$ 27,100	\$135,500
16	Income taxes per tax return (line 4)	<u>17,500</u>	<u>22,300</u>	<u>27,100</u>	<u>31,900</u>	<u>36,700</u>	<u>135,500</u>
17	Credit (debit) deferred tax account <u>48%</u> (line 2 - line 6)]	<u>9,600</u>	<u>4,800</u>	<u>- 0 -</u>	<u>( 4,800)</u>	<u>( 9,600)</u>	<u>- 0 -</u>

\*Tax rate: First \$25,000 of taxable income, 22%  
Above \$25,000 of taxable income, 48%

of the impact of income tax allocation on the reported income can be determined.

In Year I the income taxes per tax return amounts to \$17,500 while the amount of taxes reported in the income statement assuming allocation is \$27,100. The difference of \$9,600 must be credited to a balance sheet tax account, like Deferred Income Tax Liability (Section D of Table III). The corresponding amount for Year II is \$4,800. For Year III, income taxes per income statement and per tax return are of the same amount. In Years IV and V, however, the income tax based upon accounting income is exceeded by the income tax per tax return. Thus, under tax allocation, the Deferred Income Tax Liability account must be reduced by \$4,800 and \$9,600 in Years IV and V, respectively.

These two simplified illustrations serve to point up the impact of income tax allocation upon the reported earnings of enterprises as well as indicate the basic accounting procedures involved in income tax allocation. The obvious effect of tax allocation is that it smooths net income (Section C of Tables II and III). Thus, the central problem of tax allocation is how to determine the proper tax charge for each period--whether the reported tax expense should be based on business income or taxable income.

## B. HISTORICAL PERSPECTIVE

In order to place the arguments which have been hurled back and forth concerning the merits of interperiod tax allocation in

their proper perspective, the highlights in the development of income tax allocation are first briefly reviewed. Such a survey points up the circumstances which have given emergence to interperiod tax allocation as one of the most controversial accounting issues today.

American Institute of Certified Public Accountants

Tax effect accounting for bond discount amortization. The first step, which was to lead unsuspectingly three years later into a major controversy, was taken by the American Institute of Certified Public Accountants in September, 1939 with the issuance of Accounting Research Bulletin No. 2, "Unamortized Discount and Redemption Premium on Bonds Refunded." The Institute's Committee on Accounting Procedure recommended two alternatives for disposing of unamortized discount and redemption premium on a refunded bond issue: (1) a direct write off to earned surplus, or (2) spreading the amount over the original life of the refunded bonds.<sup>8</sup>

In December, 1942 the first support was given for tax allocation. This took the form of Accounting Research Bulletin No. 18, which was issued as a supplement to ARB No. 2. The following statement summed up the historic conclusions of ARB No. 18:

When unamortized discount on bonds refunded is written off in full in the year of refunding, it is sound accounting

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<sup>8</sup>American Institute of Accountants, Committee on Accounting Procedure, "Unamortized Discount and Redemption Premium on Bonds Refunded," Accounting Research Bulletin No. 2 (New York: American Institute of Accountants, 1939), p. 13.

to show such charges as a deduction in the income statement in the year of refunding in harmony with the treatment required for income tax purposes. Where any write-off is made through surplus it should be limited to the excess of the unamortized discount over the reduction of current taxes to which the refunding gives rise, and there should be shown as a deduction . . . in the income statement for the year of refunding an amount at least equal to such reduction in current taxes.<sup>9</sup>

The Committee then cast the die for between period allocation:

If the alternative of spreading unamortized discount over a future period is adopted, a charge should be made . . . in the income statement in the year of refunding equal to the reduction in current income tax resulting from the refunding.<sup>10</sup>

Accounting Research Bulletin No. 23. Two years later the theme of income tax allocation was driven home when the Committee on Accounting Procedure announced in ARB No. 23 that "income taxes are an expense which should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated."<sup>11</sup>

It has subsequently been argued that the principal concern of the Committee in ARB No. 23 was confined to intraperiod tax allocation

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<sup>9</sup>American Institute of Accountants, Committee on Accounting Procedure, "Unamortized Discount and Redemption Premium on Bonds Refunded (Supplement)," Accounting Research Bulletin No. 18 (New York: American Institute of Accountants, 1942), p. 151.

<sup>10</sup>Ibid.

<sup>11</sup>American Institute of Accountants, Committee on Accounting Procedure, "Accounting for Income Taxes," Accounting Research Bulletin No. 23 (New York: American Institute of Accountants, 1944), p. 183.



and that few, if any, contemplated the far reaching extension of the idea of interperiod allocation.<sup>12</sup> Such a position seems to be contrary to Paragraph 4 of ARB No. 23 which stated:

Where an item resulting in a material reduction in income taxes is charged to or carried forward in a deferred-charge account . . . it is desirable to include a charge in the income statement of an amount equal to the tax reduction . . .<sup>13</sup>

Clearly, the Committee took full cognizance of interperiod tax allocation in preparing its pronouncement as recorded in ARB No. 23 which was entirely consistent with the then in force ARB No. 18.

Tax effect accounting for emergency facilities. Even though ARB No. 23 was received with mixed emotions, the principle of interperiod tax allocation had become sufficiently accepted by 1952 to allow for a further expansion of tax effect accounting. In 1952, ARB No. 42, dealing with "Emergency Facilities--Depreciation, Amortization, and Income Taxes," was issued. This pronouncement called for accounting recognition, where material, of the income tax effect of differences between book depreciation and depreciation per tax return which results from fast tax-write off (over a five year period) of certain assets, called emergency facilities by the tax law.<sup>14</sup> Of course such a

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<sup>12</sup>Henry T. Chamberlin, "Tax Allocation Controversy" (letter), The Journal of Accountancy, CVI (October, 1958), 26-27.

<sup>13</sup>American Institute of Accountants, Committee on Accounting Procedure, "Accounting for Income Taxes," op. cit., pp. 185-186.

<sup>14</sup>American Institute of Accountants, Committee on Accounting Procedure, "Emergency Facilities--Depreciation, Amortization, and Income Taxes," Accounting Research Bulletin No. 42 (New York: American Institute of Accountants, 1952), p. 310.

practice, unless some adjustment was made, would usually have a significant impact on reported earnings for a given period. To overcome the resulting income distortion, interperiod income tax allocation was recommended.

The next move by the American Institute of Certified Public Accountants involving interperiod tax allocation was the issuance of a "Restatement and Revision of Accounting Research Bulletins" Nos. 1-42. This updating took the form of Accounting Research Bulletin No. 43 issued in 1953. The essence of ARB No. 23 and 42 was retained in Section C of Chapters 10 and 9, respectively. Thus, the Committee's attitude concerning interperiod tax allocation seemed firmly implanted.

Rejection of deferred income tax recognition. The next significant pronouncement by the Institute which was concerned with differences in timing for accounting and tax purposes was ARB No. 44 issued in 1954. Specifically, the primary issues dealt with in ARB No. 44 concerned situations in which an accelerated depreciation method was used for income tax purposes, as permitted by Section 167 of the 1954 Internal Revenue Code, but other appropriate methods were followed for financial accounting purposes. The bulletin concluded that in the ordinary case, deferred income taxes need not be recognized in the accounts.<sup>15</sup> Apparently, however, the results of the recommended

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<sup>15</sup>American Institute of Accountants, Committee on Accounting Procedure, "Declining-balance Depreciation," Accounting Research Bulletin No. 44 (New York: American Institute of Accountants, 1954), p. 1.

policy of ARB No. 44, which was directly opposite the then existing bulletins, did not prove to be altogether satisfactory.

Acceptance of tax effect accounting for accelerated depreciation.

In July, 1958 the Institute's Committee on Accounting Procedure issued a revision of ARB No. 44 which superseded the 1954 pronouncement. This revised bulletin, in reversing its predecessor, said that accounting recognition should be given to deferred income taxes if the amounts involved are material, except for some regulated companies. In addition, the bulletin permitted the handling of the income tax deferment through the depreciation or amortization accounts when desired, in lieu of using a deferred income tax account.<sup>16</sup>

With the issuance of revised ARB No. 44, consistency throughout the American Institute's pronouncements concerning interperiod tax allocation was accomplished. This brief review reflects the evolution of the AICPA's policy toward allocating income taxes between periods when there is a material effect upon the reported income caused by differences in timing in the tax treatment and financial accounting treatment of certain transactions.

Securities and Exchange Commission

While the AICPA was developing its policy in respect to interperiod tax allocation, the Securities and Exchange Commission was also at work on the same issue.

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<sup>16</sup>American Institute of Certified Public Accountants, Committee on Accounting Procedure, "Declining-balance Depreciation," Accounting Research Bulletin No. 44 (Revised), op. cit., p. 2-A.

Tax allocation first rejected. The first statement by the SEC on interperiod tax allocation was in the form of Accounting Series Release No. 53 dated November 16, 1945 and was entitled, "In the Matter of 'Charges in Lieu of Income Taxes.'" The SEC rejected increasing the provision for income taxes in the income statement above the tax estimated to be due per tax return.<sup>17</sup>

Tax effect accounting accepted. Subsequently, however, the SEC gradually had a change in attitude.<sup>18</sup> On December 30, 1958, in Securities Act Release No. 4010 the Commission proposed an administrative policy regarding the balance sheet treatment of the credit equivalent to the reduction of income taxes arising from the deduction of costs for income tax purposes at a more rapid rate than for financial statement purposes. This proposed policy was officially

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<sup>17</sup>United States Securities and Exchange Commission, "In the Matter of 'Charges in Lieu of Income Taxes,'" Accounting Series Release No. 53 reprinted in United States Securities and Exchange Commission, Accounting Series Releases (Releases 1 to 77, Inclusive) (Washington, D. C.: United States Government Printing Office, 1956), p. 128.

<sup>18</sup>See United States Securities and Exchange Commission, 22nd Annual Report (Washington, D. C.: United States Government Printing Office, 1956), pp. 70-71; United States Securities and Exchange Commission, 23rd Annual Report, (Washington, D. C.: United States Government Printing Office, 1958), pp. 38-39; and Andrew Barr, "Financial Reporting for Regulatory Agencies," The Journal of Accountancy, CV (February, 1958), 26-32.

adopted by an announcement in the form of Accounting Series Release No. 85<sup>19</sup> which stated:

Because of the interrelationship between income taxes and depreciation, the Commission is of the view that in the earlier years the charge equivalent to the tax reduction should be treated either (1) as a provision for future taxes in the income statement with a corresponding credit in the balance sheet to a non-equity caption such as a deferred tax credit, or (2) as additional depreciation in the income statement with a corresponding addition to the accumulated provision for depreciation in the balance sheet.<sup>20</sup>

The Commission added that:

recognition of tax deferment should be made in all cases in which there is a tax reduction resulting from deducting costs for tax purposes at faster rates than for financial statement purposes.<sup>21</sup>

This last statement caused accountants concern over just how far tax allocation was to be carried.<sup>22</sup> In response to this anxiety, the Commission issued Accounting Series Release No. 86 stating that it

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<sup>19</sup>For a documented account of the events which culminated in the issuance of Accounting Series Release No. 85 including the pertinent Commission releases, the written views and comments filed with the Commission, and a record of the public hearing and exhibits filed, see Arthur Andersen & Co., "SEC Administrative Policy RE: Balance-Sheet Treatment of Deferred Income-Tax Credits--Parts 1 and 2," Cases in Public Accounting Practice (Chicago: Arthur Andersen & Co., 1961), Vols. 5 and 6.

<sup>20</sup>United States Securities and Exchange Commission, "Statement of Administrative Policy Regarding Balance Sheet Treatment of Credit Equivalent to Reduction in Income Taxes," Accounting Series Release No. 85 reprinted in United States Securities and Exchange Commission, Accounting Series Releases (Releases 78 to 89, Inclusive) (Washington, D. C.: United States Government Printing Office, 1961), p. 61.

<sup>21</sup>Ibid.

<sup>22</sup>See Carman G. Blough, "Tax Allocation and the SEC," The Journal of Accountancy, CIX (June, 1960), 65-66.

was not the Commission's intention to make mandatory the use of deferred tax accounting beyond the requirements of generally accepted accounting principles.<sup>23</sup> That is to say, the Commission was now in complete accord with the AICPA's position on interperiod income tax allocation.

#### American Accounting Association

Contrasting the current position of the AICPA and SEC, is the viewpoint of the American Accounting Association. While the American Accounting Association, in a statement issued in 1948, recommended disclosure of any material consequences resulting from differences in financial and tax accounting, it stated very forthrightly that:

Such disclosures should not be made by the adjustment of the "provision for taxes" reported in the income statement; this caption should be used for the actual taxes paid or estimated payable.<sup>24</sup>

The Committee left no doubt that the amount of income tax expense that was to be reflected in the income statement was to be the amount

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<sup>23</sup>United States Securities and Exchange Commission, "Response to Comment on Statement of Administrative Policy Regarding Balance Sheet Treatment of Credit Equivalent to Reduction in Income Taxes," Accounting Series Release No. 86 reprinted in United States Securities and Exchange Commission, Accounting Series Releases (Releases 78 to 89, Inclusive) (Washington, D. C.: United States Government Printing Office, 1961), p. 63.

<sup>24</sup>American Accounting Association, Executive Committee, "Accounting Concepts and Standards Underlying Corporate Financial Statements--1948 Revision," Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus, Ohio: American Accounting Association, 1957), p. 18.

computed on the tax return. This position was reiterated in the AAA's 1957 statement which concluded that income tax deferment via interperiod tax allocation "may be more confusing than enlightening and is therefore undesirable."<sup>25</sup> This latest statement on interperiod tax allocation by the American Accounting Association places this group at opposite poles from that of the AICPA and SEC.

With this division of the major accounting bodies over interperiod tax allocation, it is not difficult to visualize how the storms of controversy have gathered. The following sections of this chapter examine the basis for each position in an attempt to establish which approach is more consistent with existing accounting theory and at the same time seek to determine which technique more nearly fulfills the utilitarian role of financial reporting.

### C. OPPOSITION TO INTERPERIOD TAX ALLOCATION

#### Income Normalization

Perhaps the most often expressed reason for rejecting interperiod tax allocation is that such a procedure is simply a technique to stabilize the reported earnings figures. The practice of adopting arbitrary accounting policies for the sole purpose of presenting a record of stable earnings has long been subject to disrepute by accountants.

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<sup>25</sup>American Accounting Association, Committee on Accounting Concepts and Standards, "Accounting and Reporting Standards for Corporate Financial Statements--1957 Revision," Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (Columbus, Ohio: American Accounting Association, 1957), p. 7.

The argument against tax allocation states that financial accounting is essentially historical in nature. That is to say, it consists of an accounting for costs that have actually been incurred by the business and for the revenues that have been actually derived from the business. The preparer of financial statements has no place trying to "normalize" the results of the year's operations. These accountants argue that inasmuch as income tax allocation is an attempt to reflect the "normal" earning power of the enterprise, it should not be adopted. The earnings statements should reflect only actual operations in accordance with the historical data; they should not be altered to reflect amounts that the preparer considers to be more normal or likely to recur in the future.<sup>26</sup> William Vatter summed up this position when he stated that a concept of income based upon a presumed ultimate settlement with the Internal Revenue Service, after the complexities of legislative and administrative confusions have been (presumably) ironed out, is not a very realistic and useful result.<sup>27</sup> In brief, to the opponents of tax allocation, it seems that the advocates of tax effect accounting feel that one item, namely income tax expense, should be "distorted" in a given period in order to avoid "distortion" of the final net income for the same period.<sup>28</sup> The former group accuses the latter group with circular reasoning.

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<sup>26</sup>United States Securities and Exchange Commission, "In the Matter of 'Charges in Lieu of Income Taxes,'" op. cit., pp. 145-146.

<sup>27</sup>William J. Vatter, "Another Look at the 1957 Statement," The Accounting Review, XXXVII (October, 1962), 665.

<sup>28</sup>Ralph S. Johns, "Allocation of Income Taxes," The Journal of Accountancy, CVI (September, 1958), 44.



### The Nature of the Deferral

If complete income tax allocation is followed, the amount of the tax deferral will give rise, it will be recalled, to a balance sheet tax account. If initially taxable income exceeds business income, the balance sheet tax account will have a debit balance. Popular belief holds that the deferral in this case should appear on the asset side of the balance sheet and be given a title like Deferred Income Tax Expense. On the other hand, if initially the business income exceeds the taxable income, the related balance sheet tax account will have a credit balance which is often classified as a liability.

Not an asset. Opponents of tax allocation contend that the amounts which would be recorded as Deferred Income Tax Expense do not represent prepayments at all. In reality, the taxpayers have not prepaid their taxes, it is argued, because in a given period the taxpayers have no claim against the government. They have merely paid the amount for which they are legally responsible and no more.<sup>29</sup>

Tax allocation opponents point out that assets are "economic resources devoted to business purposes within a specific accounting entity; these resources are aggregates of service-potentials available for or beneficial to expected operations."<sup>30</sup> In the opinion of these

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<sup>29</sup>M. Bruce McDonald, "Accounting for Income Taxes," The Federal Accountant, XII (June, 1963), 40-51.

<sup>30</sup>American Accounting Association, Committee on Accounting Concepts and Standards, "Accounting and Reporting Standards for Corporate Financial Statements--1957 Revision," op. cit., p. 3.

accountants, it is difficult to see how the so-called "payment" of a tax before the income is earned by the enterprise, tax allocation notwithstanding, gives rise to expected future economic resources. Accountants opposed to tax effect accounting conclude that entries to record a Prepaid Income Tax or Deferred Income Tax Expense in the records of an accounting entity will have no effect in the least on bona fide business transactions of future accounting periods.<sup>31</sup>

In rejecting the position that a tax deferral debit is a valid asset, opponents of tax allocation have stated that such an account does not represent a "receivable and surely the Federal Government would disavow it."<sup>32</sup> For similar reasons, Thomas Hill found it difficult to accept the prepaid income tax account as an asset for he stated: "While it purports to be an advance payment, it is unlike any conventionally recorded receivable in that it is explicitly not recognized as such by the recipient."<sup>33</sup>

Not a liability. Similar objections are raised to describe as a liability the credit balance resulting when tax payments initially are less than the tax expense based on business income. The creation of a deferred tax liability is one of the most frequent situations

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<sup>31</sup>Arnold W. Johnson, "'More' on 'Income-Tax-Allocation' Accounting," The Accounting Review, XXXVI (January, 1961), 77.

<sup>32</sup>Weldon Powell, "Accounting Principles and Income-Tax Allocation," The New York Certified Public Accountant, XXIX (January, 1959), 26.

<sup>33</sup>Thomas M. Hill, "Some Arguments Against the Inter-Period Allocation of Income Taxes," The Accounting Review, XXXII (July, 1957), 359.

encountered in modern day corporate financial reporting due mainly to the widespread use of accelerated depreciation for tax purposes. James Dohr expressed the general sentiment opposing such a procedure when he stated:

The Revenue Act may in a sense result in a deferral of tax, but there is obviously no deferral of tax liability--there is no tax liability to defer. The statute levies no future tax, and upon payment of the tax for the current year there is, at the end of the year, no further tax liability of any kind or description.<sup>34</sup>

Thomas Hill again expressed a similar conviction when he stated that "the amount shown under this caption (liability for deferred taxes) represents, not what the firm is liable for, but what the firm expects to be liable for at some future time."<sup>35</sup> Or as Delmer Hylton reflected, "there is no present accounting income on which taxes must be paid in the future, unless future events cause the payment."<sup>36</sup>

It is further argued by the opponents of tax allocation that since there is no claim by the United States Treasury, how can there be a liability. In this regard, McDonald asked a very pointed question:

If he (a proponent of tax allocation) were an advocate for his client, what defense would he make, on behalf of his client, against the United States Government, if the

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<sup>34</sup>James L. Dohr, "Tax Allocation" (letter), The Journal of Accountancy, CVII (February, 1959), 19.

<sup>35</sup>Hill, op. cit., p. 358.

<sup>36</sup>Delmer P. Hylton, "Income Tax Allocation" (letter), The Journal of Accountancy, CVII (May, 1959), 26.

Government asserted a right to collect all amounts recorded in the taxpayer's accounts as deferred tax liabilities?<sup>37</sup>

Arnold Johnson pursued this line of analysis to its logical conclusion when he pointed out that one of the fundamental precepts of existing accounting theory is that anything of economic value is matched by financial claims against these values. These claims, held by legal persons, are of only two kinds: (1) liabilities, claims of creditors, and (2) the claims of the owners. The deferred tax account with a credit balance fits neither of these; it is, therefore, not a liability.<sup>38</sup> In addition, the deferred tax account with a credit balance does not meet the definition of liabilities as cited by the American Accounting Association:

The interests or equities of creditors (liabilities) are claims against the entity arising from past activities or events which, in the usual case, require for their satisfaction the expenditure of corporate resources . . .

The discharge of a liability at a determinable date is normally required by contract or intent of parties.<sup>39</sup>

Clearly the opponents of interperiod tax allocation feel that they stand on firm ground when they reject tax allocation on the basis that the "prepayment" is not an asset nor the "deferred" tax is not a liability.

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<sup>37</sup>McDonald, op. cit., p. 51.

<sup>38</sup>Johnson, op. cit., p. 76.

<sup>39</sup>American Accounting Association, Committee on Accounting Concepts and Standards, "Accounting and Reporting Standards for Corporate Financial Statements--1957 Revision," op. cit., p. 7.

### Assumptions of Tax Deferral

Aside from the fact that the balance sheet accounts resulting from interperiod tax allocation do not fit within the general definition of assets or liabilities, opponents of tax allocation maintain that the creation of such accounts is based upon a series of assumptions which in many cases may turn out to be contrary to factual experience. The foremost assumption, of course, is that there will be future income. Further, some future tax rate has to be assumed. Third, it is assumed that an alteration of the tax rate structure will not take place which will upset the allocation procedure. The fourth assumption is that the tax will not be permanently deferred. The dissenters to tax allocation feel that each of these assumptions are cause enough to reject tax allocation.

Permanent deferral. The idea that the tax may be permanently deferred, and as a result tax allocation would be ineffective, permeates almost every discussion opposing tax allocation. For example, Sidney Davidson pointed out that if the following two questions can be assumed to be answered in the affirmative, then there is no basis for tax allocation. These questions were: "Are tax rules for depreciation methods expected to remain as generous as they now are?" and, "Will a policy of regular investment in assets subject to depreciation be maintained?"<sup>40</sup> If a positive answer is

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<sup>40</sup>Sidney Davidson, "Accelerated Depreciation and the Allocation of Income Taxes," The Accounting Review, XXXIII (April, 1958), 173.

given,<sup>41</sup> then the tax deferral will never have to be paid for the deferral is permanent. Consequently, the resulting realized tax saving should be reflected in the reported income of the enterprise during its active life.<sup>42</sup> John Coughlan, in explaining how the permanent tax deferral would come about under an expanding investment program, stated:

Before any deferral on the first asset can be paid (before straight-line depreciation used for accounting purposes exceeds depreciation per tax return), a new depreciable asset may be purchased and a further tax reduction permitted, with the net effect that some part of the tax deferral is deferred indefinitely. What happens is that, during the early years, accelerated depreciation and a large tax deferral is rapidly accumulated. No time comes, however, when accelerated depreciation falls below straight-line depreciation. Consequently, the deferred taxes are deferred forever-- they are never paid!<sup>43</sup>

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<sup>41</sup>As did Dale S. Harwood, Jr., "Yet More on Tax Allocation," The Accounting Review, XXXVI (October, 1961), 621-623. For a more technical analysis supporting the permanent postponement thesis, see Robert Eisner, "Depreciation Under the New Tax Law," Harvard Business Review, XXXIII (January-February, 1955), 66-74.

<sup>42</sup>It is interesting to note that the AICPA, now an avid supporter of interperiod tax allocation, used this argument in supporting ARB No. 44 as originally issued which opposed tax effect accounting. The Committee "had in mind the typical industrial enterprise where replacements of depreciable assets take place with considerable regularity or where there is gradual expansion of physical facilities. In such cases, if deferred income taxes were recognized in the accounts, a liability balance would be built up which would be reduced only during a period of contraction or liquidation." Carman Blough, "Some Questions on Bulletin No. 44," The Journal of Accountancy, IC (March, 1955), 68.

<sup>43</sup>John W. Coughlan, "Tax Reductions and Tax Deferrals," The Journal of Business, XXXI (April, 1958), 125. See also J. W. Crowe, "A Look at Depreciation and Income Taxes," The Canadian Chartered Accountant, LXIX (July, 1956), 45-53.

Deferral increases. Michael Ochis, in making a thorough review of the advantages and disadvantages of accelerated depreciation, further established that even if each asset retirement is replaced by an equal cost asset addition there will be a continuing deferment of the tax payment. Ochis was also of the opinion that the amount of deferred taxes permanently postponed can be expected to increase, as each dollar of retired asset will in all likelihood engender more than one dollar of additions. He pointed to two factors in support of this conclusion: (1) an increased price level, and (2) the continued improvement of production technology which is generally reflected in replacement of existing equipment and manpower by more or larger equipment with less manpower.<sup>44</sup> These are additional factors which seemingly support the idea that deferred taxes are permanently deferred and hence rules out interperiod tax allocation.

Subjectivity and uncertainty. It is frequently pointed out that interperiod tax allocation is full of assumptions about the future. Opponents of tax allocation never fail to mention that deferred tax accounting is not restricted to a reporting of what has happened but extends beyond this point to a forecast of what will happen in the future. It is argued that such an extension obviously exceeds the accountant's acknowledged responsibility insofar as his examination

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<sup>44</sup>Michael Ochis, "Pros and Cons of Accelerated Depreciation," L. R. B. & M. Journal, XXXVII (October-December, 1956), 10.

of and reporting on financial statements goes.<sup>45</sup> To implement the allocation principle, the forecaster must rely heavily upon his subjective judgment. Financial reporting should be objective. Otherwise, the informational content of the report is inevitably reduced, and even sometimes distorted.<sup>46</sup>

In short, the position is taken by opponents of tax allocation that there are too many uncertainties associated with between years allocation; about future tax rates; about future expansion and replacement policies of the firm; and about whether there will be future income. Potential confusion from tax allocation outweighs potential added usefulness to financial statements. Therefore, although the matter is one requiring disclosure, footnotes are a more appropriate means than are tax effect accounting procedures.<sup>47</sup>

#### Presumption Against Allocation

In brief, the arguments against tax allocation maintain that the possible future offsets to artificially created balance sheet tax accounts are often so subject to unusual uncertainties; deferred tax accounting in so many cases may be unduly complicated; and disclosure

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<sup>45</sup>McDonald, op. cit., p. 47. See also United States Securities and Exchange Commission, "In the Matter of 'Charges in Lieu of Income Taxes,'" op. cit., pp. 143-148.

<sup>46</sup>Hill, op. cit., p. 361.

<sup>47</sup>See Herbert E. Miller, "How Much Income Tax Allocation?" The Journal of Accountancy, CXIV (August, 1962), 47.



by accrual may be more confusing than enlightening. Therefore, such techniques are undesirable.<sup>48</sup>

Weldon Powell summed up the general feeling of the advocates of non-allocation of income taxes:

I would start with the presumption that the tax paid or payable for a given period should be shown as a charge in the period for which it is paid. I would depart from this presumption only to correct an obvious distortion of income or to avoid an income presentation which might be misleading. In other words, I think the presumption should be against allocation.<sup>49</sup>

The admonition of the above described accountants is: "Let the reported tax expense follow the tax return!"

#### D. SUPPORT FOR INTERPERIOD TAX ALLOCATION

As reported earlier in this study, the American Institute of Certified Public Accountants and the Securities and Exchange Commission are currently on record recommending interperiod tax allocation. Apparently, then, some rather convincing arguments can be presented in behalf of interperiod tax allocation.

##### More Accurate Income Reporting

The key argument in support of interperiod tax allocation is that it yields more accurate income reporting. Tax effect accounting

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<sup>48</sup>American Accounting Association, Committee on Accounting Concepts and Standards, "Accounting and Reporting Standards for Corporate Financial Statements--1957 Revision," op. cit., p. 7.

<sup>49</sup>Powell, op. cit., p. 28.

avoids overstating net income in the early years (for instance in the case of the utilization of accelerated depreciation methods for tax purposes but not for accounting purposes) when the tax reduction is the greatest and understating net income in the later years when the tax payable exceeds the tax based on business income. Hence, tax allocation seeks to produce the same total revenue deductions as would have been reported had there never been a difference in taxable and business income.

This "normalization" of reported net income via tax allocation is defended on the grounds that since the value of a business is derived from its income pattern, every step possible should be taken to report earnings as realistically as possible. Tax deferrals "represents one of the approaches to the sharpening of the methods of determining net earnings."<sup>50</sup> As a case in point, Alan Cerf, after presenting a somewhat rigorous analysis of the way alternative treatments of the "tax effects" arising from differences in timing are reflected in the operating results of enterprises, concluded that the "tax allocation procedure is the superior method from the standpoint of investment decision-making."<sup>51</sup>

These conclusions are based on the premise that when the tax based on business income initially exceeds the tax per tax return,

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<sup>50</sup>Hans J. Shield, "Allocation of Income Taxes," The Journal of Accountancy, CIII (April, 1957), 53.

<sup>51</sup>Alan R. Cerf, "Tax Allocation and Investment Decisions," The California Management Review, III (Fall, 1960), 49.

the income statements may reflect a result which is likely to lead the reader into an overestimation of future earning power.<sup>52</sup> Conversely, when the tax per tax return initially exceeds the tax per business income, without allocation the reader may be led to an underestimation of future earning power. Thus, it is concluded that tax allocation is necessary for fair, realistic income reporting. To do otherwise, these accountants argue, results in inaccurate reporting and perhaps even in a disservice to the user of the statement.<sup>53</sup> In short, statement users may be misled in appraising the profit potential and control of future operations if there is a failure to allocate income taxes.

#### Provides an Equitable Matching of Expenses and Revenues

The position that income tax allocation is necessary to reflect a realistic earnings picture is grounded in the basic accounting tenet that such procedures accomplish an equitable matching of costs and revenues. In other words, the proponents of tax allocation argue that there must be an allocation of income tax expense among periods in relation to the business income rather than the taxable income. Willard Graham has stated this position well:

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<sup>52</sup>For example, consider the following quote: "The failure to set up such a reserve (for deferred taxes) results in an overstatement of business income." Willard Graham, "The Application of Declining-Amount Methods of Depreciation to Financial and Cost Accounting," The Ohio Certified Public Accountant, XV (Winter, 1956), 10-11.

<sup>53</sup>Robert L. Carr, "Allocation of Federal Income Tax--Review and Explanation," N.A.A. Bulletin, XLIV (December, 1962), 10.

The reduction in income tax which results from additional depreciation deductions for tax purposes . . . should not, in my opinion, be considered an immediate savings in expense to be reflected in current income . . . A tax reduction which is directly related to a corresponding item of expense . . . should not be reflected as a credit to income until the corresponding expense is charged to income.<sup>54</sup>

Oponents to tax allocation generally do not attack the position that such procedures do provide for a more equitable matching of expenses and revenues, rather they present other arguments which are often open to serious question like the permanent deferral argument.

#### Objections to Permanent Tax Deferral Thesis

Government loan viewpoint. In answer to the argument that the tax deferral is permanent, in the case of accelerated depreciation, Jaedicke and Nelson have presented a case for considering the deferred tax credit as a government "loan." They drew an analogy with an expanding firm which increases its accounts payable over time and thus becomes a type of permanent liability that is never likely to be paid until liquidation of the firm. True, the original accounts will be paid, but additional debts are incurred in an increasing amount. The same principle, in their opinion, holds for the "income tax loan."

If the income tax is levied on "one asset," it is true that in the later years of life the firm will pay the government

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<sup>54</sup>Willard J. Graham, "Income Tax Allocation," The Accounting Review, XXXIV (January, 1959), 15-16.

back part of the "loan" that it received in the early years. However, in an expanding firm, another asset will be purchased in the second period which will give the firm more "borrowing power" and the "tax loan" . . . will at least remain the same or perhaps increase in amount.<sup>55</sup>

Continuous turnover. Graham presented a similar case when he pointed out that the total deferral for any corporation is that net effect of two sets of repetitive transactions:

(a) the periodic additions to the potential future tax liability which arises from successive deductions for tax purposes prior to recognition as expense, and (b) the "maturing" of segments of this liability, periodically, as there are recognized as expenses the items which have been taken as deductions for tax purposes in prior periods.<sup>56</sup>

Then Graham posed the question:

Just when do we stop . . . in accepting the principle that the incurrence of a liability (and the attendant expenses) may be ignored if there is a probability that when the liability matures--and it is paid--the funds for the payment will be provided by the incurrence of another liability--which in turn--and so, ad infinitum?<sup>57</sup>

Expansion assumption. George Richardson, in answering the objection that tax deferrals are permanent in respect to plant assets pointed out that such objections rest on the assumption that the firm will expand. At best the rate of expansion, in his opinion, is a matter of great uncertainty. Furthermore, even though expansion may be continuous over time, it may occur at infrequent intervals in

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<sup>55</sup>Robert K. Jaedicke and Carl L. Nelson, "The Allocation of Income Taxes--A Defense," The Accounting Review, XXXV (April, 1960), 279.

<sup>56</sup>Graham, "Income Tax Allocation," op. cit., p. 20.

<sup>57</sup>Ibid.

large units and in between there may be many years in which the tax depreciation will be less than book depreciation, which may greatly reduce the accumulated deferred tax credit, even though it does not completely eliminate it.<sup>58</sup> In essence, the deferral may not have a very permanent nature at all.

Going concern assumption. Objectors to tax allocation often defend the "permanence" of the tax deferral on the going concern assumption. That is, they argue that it is valid to assume that a firm will continue to grow or be active, never decreasing its investments in depreciable assets, under the continuity of existence assumption. In reply to this argument, J. E. Sands pointed out that since no business lasts forever, it would hardly be valid to consider deferred taxes a permanent gain on the ground that a business will never die. In his opinion:

The going-concern assumption cannot be used to justify such an interpretation. The going-concern assumption is made to provide a basis for allocating long-term costs and revenues and requires only that one assume the business will last longer than any of its assets or liabilities. It is an unwarranted extension of this assumption to interpret it to mean that all going businesses have infinite lifetimes.<sup>59</sup>

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<sup>58</sup>George G. Richardson, "Does Diminishing Balance Depreciation Result in Real and Permanent Tax Savings?" The Canadian Chartered Accountant, LXX (June, 1957), 524.

<sup>59</sup>J. E. Sands, "Deferred Tax Credits Are Liabilities," The Accounting Review, XXXIV (October, 1959), 585.

## E. SUMMARY AND APPRAISAL

There are numerous instances where the tax law calls for recognition of transactions in different periods than is generally accepted for financial reporting purposes. Without doubt, the most common and important case is where liberalized depreciation is allowed for tax purposes but not followed for accounting purposes. Tax effect accounting, commonly called interperiod tax allocation, attempts to record in the accounts these timing differences.

At the present time, the American Institute of Certified Public Accountants and the Securities and Exchange Commission support interperiod tax allocation while the American Accounting Association is opposed to tax deferral accounting.

The general opposition to interperiod tax allocation maintains that such techniques simply are income normalization devices and as such should be rejected. Further, it is argued that the tax deferral, in the case of depreciation, is permanent and therefore should not be recognized in the accounts. Finally, the argument is presented that tax allocation accounting involves too much subjectivity and uncertainty; the accountant should have no part of such techniques.

On the other hand, proponents of tax effect accounting offer rather convincing rebuttals to each of these propositions. First, the contention that interperiod tax allocation is merely an income normalization device is unsound. Tax effect accounting is firmly based in contemporary accounting theory for it is simply a procedure for providing a more equitable matching of expenses with revenues.

Tax deferrals represent one of the approaches to the sharpening of the methods of determining net earnings. It is no more of an income normalization device than are many of the other accounting practices adhered to in accrual accounting.

The second argument--that tax deferrals are permanent and hence do not need recognition in the accounts--is also an inadequate objection to tax deferral accounting. This study has shown rather conclusively that the tax reduction is no more permanently deferred than are accounts payable for an expanding enterprise. There are continuous additions and reductions to the deferred tax account and therefore do need recognition.

Third, the argument that tax deferral accounting is plagued with too much subjectivity and uncertainty does not provide enough convincing evidence to warrant rejecting this approach to sound income reporting.

Once it is accepted that interperiod tax allocation is a more realistic approach to income determination, then and only then, should attention be directed to the problems of implementing such a procedure. As opponents to tax allocation are quick to point out, one of the first problems which must be resolved is the proper balance sheet reporting of the tax deferrals. This and other problems surrounding the practice of interperiod tax allocation are considered next.



## CHAPTER V

### IMPLEMENTATION PROBLEMS OF INTERPERIOD TAX ALLOCATION

The analysis of the previous chapter concluded that in light of the current emphasis placed upon the reported earnings rather than the financial position of a firm, interperiod tax allocation is a realistic approach to financial reporting. Implementing the practice of interperiod tax allocation, however, gives rise to several immense problems for the accountant. For example, the accountant must resolve the classification problem for reporting the tax deferral on the balance sheet. In addition, he must determine the proper adjustments, if any, occasioned by a change in corporate income tax rates. These are the principal problems of interperiod tax allocation considered in this chapter.

#### A. AN EXAMINATION OF THE PROPOSALS FOR CLASSIFICATION OF TAX DEFERRALS

For some time, accountants have struggled with the tax-deferral-classification problem associated with the practice of interperiod income tax allocation. In the discussion of the objections to interperiod tax allocation, it will be recalled that the opponents of tax effect accounting pointed to this classification problem and concluded that tax allocation should not be practiced. In their opinion,

tax deferrals are neither assets nor liabilities. One of the premises of this study, however, is that realistic income reporting should not be superseded by balance sheet classification difficulties. In other words, interperiod income tax allocation should not be discarded simply because the tax deferrals may not meet the conventional definitions for assets and liabilities.

The next section of this study will critically examine each of the proposals which have been offered for reporting the tax deferrals in an attempt to delineate which alternative best fits within the existing framework of accounting theory.

#### Flow-Through Method

One of the first suggested treatments of the tax reduction, particularly where differences in depreciation methods gave rise to the timing differences, was to consider the tax savings as a part of owners' equity. For rather obvious reasons public utilities have been strong supporters of this treatment.

Criticisms. There is little justification, however, for considering the tax deferral a part of owners' equity. Bringing the tax reduction, in the case of using accelerated depreciation for tax purposes but not for book purposes, into shareholders' equity means bringing it into retained earnings; the tax savings is said to "flow-through" to undistributed earnings. The result of such a technique, of course, gives the anomaly of reducing profits and then using the

reduction to increase surplus.<sup>1</sup> In addition, deferred taxes should not be included in stockholders' equity since they do not represent earnings or invested capital. Surely, the advocates of the "flow-through" method would discard such a technique if they ever thought that taxable income would exceed business income.

Official recognition lacking. Because there is little, if any, justification for such a reporting technique for tax deferrals, the AICPA's Committee on Accounting Procedure endeavored to issue a letter in April, 1959, interpreting ARB No. 44 (Revised) as meaning that credits arising from provisions for deferred taxes were not to be included in the stockholders' equity section of the balance sheet.<sup>2</sup> Three utility companies sought an injunction to restrain the Committee from issuing such a letter at the time. After some delay, the letter was issued and the AICPA's position against the "flow-through" technique was established.<sup>3</sup> Subsequently, the SEC also has stated its

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<sup>1</sup>Edward W. Netten, "Depreciation and Taxes--Theory and Practice," The Canadian Chartered Accountant, LXXI (December, 1957), 546.

<sup>2</sup>American Institute of Certified Public Accountants, Committee on Accounting Procedure, letter dated April 15, 1959, "To the Members of the American Institute of Certified Public Accountants," reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961), p. 1.

<sup>3</sup>For a documented account of these events, see Arthur Andersen & Co., "The AICPA Injunction Case, Re: ARB No. 44 (Revised)," Cases in Public Accounting Practice (Chicago: Arthur Andersen & Co., 1960), Vol. 1.

dislike for the "flow-through" method.<sup>4</sup> Accordingly, the proposal for considering the tax deferral as part of owners' equity has slipped into oblivion, hopefully never again to be resurrected.

#### As a Deferred Item

A second alternative to reporting the tax deferrals which has been proposed is to classify the related tax accounts as either a deferred charge, in the case of debit balances, or as a deferred credit, in the case of credit balances. It is argued by the proponents of this proposal that such a classification emphasizes the true nature of tax deferrals. That is, these accounts merely represent items held in "suspense" awaiting their proper time to be assigned to the income statement. For instance, in the case of a deferred tax credit, the charge for the tax reduction represents a benefit to be brought into the income measurement process of later periods. Its nature, so it is argued, is that of a deferred credit to a future expense charge, namely the charge for income taxes.<sup>5</sup>

A "third" section. Two possibilities for classifying the deferred tax credit have been offered. One is to place the deferred credit

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<sup>4</sup>United States Securities and Exchange Commission, "Statement of Administrative Policy Regarding Balance Sheet Treatment of Credit Equivalent to Reduction in Income Taxes," Accounting Series Release No. 85 reprinted in United States Securities and Exchange Commission, Accounting Series Releases (Releases 78 to 89, Inclusive) (Washington, D. C.: United States Government Printing Office, 1961), p. 61.

<sup>5</sup>Lawrence G. Macpherson, "Capital Cost Allowances and Income Taxes," The Canadian Chartered Accountant, LXV (December, 1954), 358.

between the liabilities and owners' equity section of the balance sheet.<sup>6</sup> Such a presentation gives rise to a "third" classification on the right-hand side of the balance sheet. Conventional accounting theory holds that there are only two kinds of financial claims against an accounting entity. These claims, held by legal persons, are: (1) liabilities, claims of creditors, and (2) the claims of owners. There is no provision for a "third" type of claim. Therefore, a presentation of a "third" section on the right-hand side of the balance sheet is not in accordance with accepted accounting theory and practice.

Many accountants maintain that the deferred tax credit should be included in the same category as deferred revenues. Such a position, however, clearly overlooks the obvious: the deferred tax credit is not the same thing as a deferred revenue. Deferred revenues all relate to the recording of a future service and as such clearly qualify as liabilities as defined below.

A type of liability. A second possibility for reporting the deferred tax credit, then, is to consider the tax deferral as a separate classification within the liabilities section. A deferred credit section for liabilities, however, is not in harmony with sound reporting practice for the reasons outlined in Chapter II. Even if such a classification for liabilities were acceptable, the statement

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<sup>6</sup>Recommended by the Canadian Institute of Chartered Accountants, Committee on Accounting and Auditing Research, "Depreciation, Capital Cost Allowances, and Income Taxes," Accounting and Auditing Practices Bulletin No. 10 (Toronto: The Canadian Institute of Chartered Accountants, 1954).

preparer would, by placing deferred tax credits within this section, be labeling such an account a "liability" for its balance would be included in deriving total liabilities. The question then must be answered: Is the deferred tax credit a liability in the first place?

#### The Deferred Tax Credit as a Liability

Many advocates of interperiod income tax allocation have argued rather impetuously that tax deferrals with credit balances are liabilities. Two accountants have stood out from the rest in attempting to establish that deferred tax credits are indeed liabilities.

The economic nature of the tax deferral. First, there is J. E. Sands who has stated that deferred tax credits "are really liabilities, not necessarily liabilities in the legal sense but liabilities in the economic sense."<sup>7</sup> In supporting his position, Sands pointed to the fact that accountants have deviated from the legal concepts in the measurement of economic phenomena by setting up and amortizing such items as premiums on issue of bonds. Also, accountants record assets purchased on the installment plan at their full purchase price at the time of purchase, regardless of the fact that legal title may not pass until the last payment has been tendered. Thus, similar treatment of the deferred tax credit can be accommodated, in Sands' opinion. He would not object, however, to distinguishing between legal and economic liabilities by appropriate descriptions.<sup>8</sup>

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<sup>7</sup>J. E. Sands, "Deferred Tax Credits are Liabilities," The Accounting Review, XXXIV (October, 1959), 589.

<sup>8</sup>Ibid.

Without doubt, Sands' argument leaves something to be desired. While he does point out that there are such things as economic liabilities, he makes no attempt to establish that the deferred tax credit possesses such characteristics. Even more fundamental to his position, he makes no effort to point out the characteristics of economic liabilities in the first place. In brief, Sands falls short of clearly establishing that deferred tax credits are indeed even economic liabilities.

The relevancy of legality. It will be recalled that one of the objections to interperiod tax allocation was that the deferred tax credit account is not a legal claim against the enterprise by the U. S. Treasury. Sands was of the opinion that such an argument is irrelevant; what the government recognized should not dictate how the company should keep its books. If it did, "there would be no problem over deferred tax credits, since accounting income and taxable income would be the same."<sup>9</sup> While this position destroys an argument against the liability classification for deferred tax credits, again it is not an argument supporting a liability classification.

Sands concluded his case by stating that the same principles which apply to deferred tax credits apply equally well to deferred tax debits. The only deterrent to such a presentation for tax debits, in his opinion, is the notion of conservatism which may dictate writing off the debit balance immediately rather than setting it up

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<sup>9</sup>Ibid., p. 590.

as an asset. Conservatism, however, can be carried too far, he stated, and this may well be the case if proper asset recognition is not given to deferred tax debits.<sup>10</sup>

A comparison with accrued repair expense. The other accountant who has presented the most complete case for considering tax deferred credits as liabilities is Willard Graham. In attempting to establish that deferred tax credits are liabilities, he stated that while it is true that the tax deferrals will become payable as taxable income is realized, in the future, the balance is related to the reported income of a prior period. He compared the nature of tax deferred credits to "accrued repair and maintenance expense," which, he said, "represents an anticipated future disbursement which has been properly charged against the income of the period in which there occurred the wear and tear responsible for the repair maintenance expenditures."<sup>11</sup> The question which should be asked is an account like "accrued repair and maintenance expense" a legitimate liability? While it is not the purpose of this discussion here, it can be conclusively argued that "accrued repair and maintenance expense" is indeed not a liability. Such an account is very much like removal costs; at the point of recording such items, no benefit has been received by the firm from outsiders. Thus, the business enterprise only "owes" itself for such recorded amounts. By neglecting this point, Graham's analogy fails

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<sup>10</sup>Ibid.

<sup>11</sup>Willard J. Graham, "Allocation of Income Taxes," The Journal of Accountancy, CVII (January, 1959), 62.



to offer any real criteria for considering the deferred tax credit as a liability.

#### The Deferred Tax Debit as an Asset

In respect to deferred tax debits, Graham maintained that while the deferred amount is not explicitly recognized by the recipient, from the accounting standpoint it is definitely an advance payment. It represents a payment of an expense related to net income that will be reported on the earnings statements of future periods. Graham then concluded with the statement, "As such it would seem to qualify as a legitimate asset."<sup>12</sup>

#### An Evaluation of the Asset and Liability Classification

The opponents of tax allocation stated, it will be remembered, that since tax deferrals do not meet the usual criteria for assets and liabilities, tax deferral accounting should be rejected. This is not reason enough for abandoning a realistic approach to income reporting. Many of the advocates of tax allocation, as the above discussion reveals, do think that tax deferrals are legitimate assets and liabilities.

This controversy can easily be resolved if the characteristics of the deferred income tax accounts are tested against some standard. In the case of deferred tax credits, the appropriate test would be to determine if the tax deferral account possesses the characteristics

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<sup>12</sup>Willard J. Graham, "Income Tax Allocation" The Accounting Review, XXXIV (January, 1959), 19.

of liabilities in general. That is, (1) is it an obligation; (2) does it require a future outlay of money or its equivalent; (3) is it a result of a past or current transaction; and (4) is it subject to reliable estimation.

As an obligation. A deferred income tax credit will not qualify as a liability under the first characteristic since it is not an obligation. The term "obligation" connotes a duty to deliver assets or perform services for someone outside of the business enterprise. In addition, it also implies that there are claims or a series of claims against the company which require settlement in the future. In the case of deferred income taxes, there is no duty on the part of the company to deliver assets to the United States Treasury since this agency has no claim against the company. The opponents to tax allocation have well established this point, but, it must be emphasized they did so for the sole purpose of discrediting tax effect accounting.

The difficulty of forecasting future taxable income and tax rates does cast a slight cloud on the reliability of the amounts designated as deferred income taxes, but nevertheless, these amounts may be as reliable as much other financial data reported by accountants. In brief, even though deferred tax credits may be a liability in the economic sense as espoused by Sands, although this is not at all certain, they fail the test for liabilities as defined by generally accepted accounting theory.

Deferred tax debits as future economic benefits. In respect to deferred tax debits, they must be tested against the characteristics of assets to determine if they qualify for such a classification.

The usual criteria for assets are: (1) they must have some expected future economic benefit, and (2) they must have resulted from a past or present transaction.

Very often it is argued that deferred tax debits do have some expected future economic benefit because of the probability that the accounting entity will have to pay less taxes in the future than would otherwise have been the case if the prepaid income had not been taxed in advance of its accounting realization. This reasoning could very well be applied to, say, wages for the past week's services. If the argument was carried to its logical conclusion, it could be said, then, that wages paid today by the firm for last week's services are assets because if they are not paid today, they would have to be paid in the future--in relation to next week, they are prepayments. Clearly, such reasoning is unsound.

Furthermore, if the governmental services derived from the payment of the tax are considered, again it is difficult to relate the payment to future benefits. In the main, tax payments are for governmental services realized in the past or present. An enterprise will be able to enjoy the future services rendered by the government only if it meets its tax obligations in the future. Taxes paid in the past will not qualify for such future protection. The conclusion is, then, that no future economic benefit is derived from deferred tax debits.

While certainly the deferred tax debits do result from an actual payment of the taxes in advance, as Graham argued, the first test for assets is failed by this type of tax deferral.<sup>13</sup>

#### B. A PROPOSED PRESENTATION FOR TAX DEFERRALS

##### Deferred Tax Debits as Offsets

If deferred tax debits should not be reported in the owners' equity section of the balance sheet,<sup>14</sup> and if they are not assets, then only one alternative remains open--report such accounts as an offset to the related deferred revenue which gave rise to the tax deferral in the first instance. Can such a treatment be justified? In an attempt to answer this question, the case of rent received in advance is assumed.

A two-fold obligation. The accounting entity receiving rent in advance has two obligations in respect to such a collection. One is to either render services (the use of a physical asset) or refund the advance payment. This is an obligation to the lessee. The second obligation by the firm is to pay taxes on such revenue--obligation to the government.<sup>15</sup> By offsetting the amount of the tax that has been

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<sup>13</sup>See, however, Stephen Gilman, Accounting Concepts of Profit (New York: The Ronald Press Company, 1939), pp. 314-315 where it is argued that payment of taxes is similar in nature to the payment of insurance in advance and thus could possibly qualify as an asset.

<sup>14</sup>Supra, pp. 107-109.

<sup>15</sup>Two assumptions are implicit: (1) the rent is taxable, and (2) that the enterprise will realize taxable income in future periods in which the rent will be realized for accounting purposes.

already paid against the deferred revenue on which the tax to which the tax obligation relates reveals the firm's true net obligation outstanding in respect to the prepaid rent as of the balance sheet date. Consequently, the net amount reported as a liability as a result of receiving rent in advance meets the criteria set out earlier for liabilities: (1) the true amount of the obligation is reported, (2) the amount of the future outlay of money or its equivalent is reported, (3) it does result from past transactions, and (4) although not crucial, the amount reported is subject to close approximation. All tests for a liability are met.

As a violation of the asset-liability offset rule. It is recognized that many accountants would decry this treatment of deferred tax debits on the grounds that offsetting should not be generally practiced in balance sheet reporting. To illustrate their point, they state that mortgages payable should not be offset against, say, buildings. Here, it is granted that they do have a good case. In general, liabilities should not be offset against assets or assets against liabilities. In the case of deferred tax debits, however, it has been shown that they are not assets in the first place; therefore, the accountant's notion toward offsetting assets and liabilities is not disturbed.

As a means of informative reporting. There is an additional justification for subtracting deferred tax debits from the deferred liability. To illustrate, assume that a prospective investor is considering two companies. Further assume that the one major difference

between the two companies is that Company A has received rent in advance and has paid the tax thereon, while Company B even though it has received rent in advance has not paid the tax thereon. Obviously, under such a hypothetical situation, the prospective investor would choose Company A over Company B.<sup>16</sup> Clearly, if the practice of offsetting the deferred tax already paid against the revenue received in advance is followed by Company A, the investor would be in a much better position to make a more intelligent decision. The practice of such a reporting procedure serves a greater measure of usefulness to the potential user. In reality, this should be the ultimate test in settling classification difficulties.

#### Deferred Tax Credits as Offsets

A similar treatment for deferred tax credits seems also to be justified. That is, deferred tax credits, say arising in the accelerated depreciation cases for tax purposes, should be offset against the related fixed asset account. Again, the notion that liabilities and assets should not be offset is not disturbed because deferred tax credits are not liabilities as an earlier analysis has shown.

The two benefits derived from asset ownership. Bierman and Green were perhaps the first to suggest such a treatment for deferred

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<sup>16</sup>It should be explicitly pointed out that the cash account is assumed to be of equal amounts for both companies after the tax payment.

tax credits in respect to plant assets. They have stated that there are two things of value purchased when an asset is acquired: (1) a bundle of services, called service potentials (ability to earn revenues or reduce costs), and (2) a tax reducing potential (the right to deduct the cost of the asset from revenues in order to compute taxable income).<sup>17</sup>

To illustrate this two-fold value of an acquired asset, assume a tax rate of 48 per cent. The willingness of a firm to pay \$150,000 for an item of equipment might reflect an expected service potential net of taxes of \$78,000, and a tax benefit of \$72,000 (48 per cent of the cost). Certainly, in determining whether or not to buy, the tax effect should be considered in the financial analysis.

The use of two contra accounts. Bierman and Green in realizing the relative difficulty in dividing the asset cost into two components, suggested carrying the asset in one unexpired cost (asset) account and placing emphasis upon the use of two contra or offset accounts. The offset accounts suggested were the usual allowance for depreciation and an account which would show the net effect of the larger depreciation charge appearing on the tax return and which would be entitled "Accumulated Deductions Caused by Rapid Write-offs." Of course this amount would be the difference in taxes per tax return and per income statement (line 17 of Table III). Bierman and Green suggested

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<sup>17</sup>Harold Bierman, Jr. and David Green, "Accounting for Income-- The Problems Arising from Certificates of Necessity," The Federal Accountant, VI (June, 1957), 43.

reporting the debit to the offset account as an "Adjustment to Expense Caused by Rapid Write-off" in the income statement rather than increasing the amount of reported tax expense as reflected in line 13 of Table III.

Journal entries. Applying the above procedures to the data reflected in Table III, the entries would be as follows:

- |     |                            |          |
|-----|----------------------------|----------|
| (1) | Depreciation expense       | \$30,000 |
|     | Allowance for depreciation | \$30,000 |

To record the book depreciation for each year.

- |     |  |       |
|-----|--|-------|
| (2) | Adjustment to expense caused by rapid write-off  | 9,600 |
|     | Accumulated deductions caused by rapid write-off | 9,600 |

Adjustment to expense caused by rapid write-off	4,800
Accumulated deductions caused by rapid write-off	4,800

To record the "expense" for the accelerated depreciation and increase the related offset account for Years I and II, respectively

- |     |                      |        |
|-----|----------------------|--------|
| (3) | Income taxes expense | 17,500 |
|     | Income taxes payable | 17,500 |

Income taxes expense	23,300
Income taxes payable	23,300

To record actual income taxes owed to the government for Years I and II, respectively

After all entries had been recorded for Years I and II, the balance sheet would show:

Asset--cost	\$150,000
Less: Accumulated depreciation	
(2 years @ 30,000)	<u>60,000</u>
	\$ 90,000
Less: Deductions caused by rapid write-off (9,600 + 4,800)	
	<u>14,400</u>
	<u><u>\$ 75,600</u></u>



In Year III, no entry to the contra account would be required for deductions caused by rapid write-offs; in Years IV and V, the entries to the contra account would be reversed for Years II and I, respectively.

Advantages and justification. There are several advantages in considering the offset approach to reporting the deferred tax credit other than the fact that the classification dilemma is at last solved. First, the income statement can still report the amount of tax expense per tax return for the period. Second, the amount of the actual tax liability for the period can be reported as it would be in the liabilities section. Third, the accountant can report the fact for all to see that the particular asset has lost some of its tax reducing value.

A major justification of this method is that:

...it avoids the pretense that two assets of the same cost--exactly alike in physical and income characteristics--are of equal value if only one of them can be deducted for tax purposes. Subsequent to the period of acceleration, the asset whose depreciation was accelerated has less value for the remainder of the useful life than an asset which was similarly acquired but depreciated normally for tax purposes.<sup>18</sup>

This is an economic fact of business life which accountants have too long ignored in their reporting policies. Not only might this information influence management decisions on which assets to sell or

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<sup>18</sup>Ibid., p. 44.

replace, but also it would no doubt be a major interest to present or potential investors.<sup>19</sup>

Official recognition. The same basic approach to reporting the deferred tax credit has been approved as an acceptable alternative by the AICPA. Rather than utilizing separate contra and expense accounts, the AICPA simply suggested increasing the reported accumulated depreciation and the depreciation expense accounts, respectively.<sup>20</sup> The net effect on assets and income after taxes is the same.

Such a procedure carries with it a drawback which is in common with non-allocation. That is, the reader cannot simply take the reported net-income-before taxes figure and apply the prevailing tax rates in determining the actual tax liability for the reported income. Nevertheless, the reported tax expense under this technique would have one desirable feature. The reported tax expense would be the actual taxes paid or due for that period.

A more desirable income statement presentation for Year I would appear to be as follows:

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<sup>19</sup>For a similar analysis as presented above but which has the added feature of time discounting, see Harold Bierman, Jr., "A Problem in Expense Recognition," The Accounting Review, XXXVIII (January, 1963), 61-63.

<sup>20</sup>American Institute of Certified Public Accountants, Committee on Accounting Procedure, "Declining-balance Depreciation," Accounting Research Bulletin No. 44 (Revised) (New York: American Institute of Certified Public Accountants, 1958), p. 2-A reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

Net income before income taxes . . . . .	\$70,000
Provision for income taxes . . . . .	\$17,500
Adjustment to tax expense caused by rapid write-off of equipment . . . . .	<u>9,600</u>
Income tax expense . . . . .	<u>27,100</u>
Net income after income taxes. . . . .	<u>\$42,900</u>

The actual tax charge of \$17,500 per the tax return is reported. In addition, the total tax expense of \$27,100 can be related to the reported income of \$70,000. Complete disclosure is achieved.

#### Accounting Deductions Initially Exceeding Tax Deductions

In addition to the case involving prepaid income, a deferred tax debit also arises where the deductions for accounting purposes initially exceed the deductions allowed for tax purposes. For instance, the situation occasionally arises where a newly developed patent is sure to be obsolete in five years while the Internal Revenue Service may insist on a seventeen year amortization period. A similar situation arises in connection with certain research and development costs where accelerated amortization is used for accounting purposes while a longer write-off period is required for tax purposes.

In each of these cases, initially the taxable income exceeds the accounting income resulting in a deferred tax debit. The difference in the accounting income and the taxable income is not due to greater taxable revenue as in the case of rent received in advance discussed earlier, but rather the difference springs from the initial deduction per tax return exceeding the deduction per income statement. For this reason, a deferred tax debit under these circumstances is quite

different from that of prepaid rent and, as a result, requires a different analysis.

The principal question to be resolved is how should this deferred tax debit be reported on the balance sheet. Again, it seems that the answer may be implicit in the Bierman-Green analysis as presented in connection with accelerated depreciation. As pointed out earlier, there are two things of value purchased when an asset is acquired: (1) a bundle of services, called service potentials and (2) a tax reducing potential. The same can be said for patent costs, research and development costs and of all other similar expenditures. Certainly the tax effects of any alternative are considered by management in making the initial decision. To this end, then, just as the amortization of the service potential is reported, so should be the expiration of the tax-reducing-potential value of the original outlay.

An illustration. For purposes of illustration, assume that at the beginning of Year I, patent costs are capitalized in the amount of \$17,000. A five year write-off period is used for accounting purposes while a seventeen year period is required for tax purposes. Further assume income to be in excess of \$25,000 for each year under consideration. Therefore, using current rates, a marginal income tax rate of 48 percent would be applicable. Column D of Table IV presents the amount of the deferral for each year under these circumstances.

The usual patent amortization would be recorded for Years I-V as follows:

Amortization of Patents	\$3,400	
Patents		\$3,400

TABLE IV  
PATENT AMORTIZATION -- AN ILLUSTRATION

	A	B	C	D	E
End of Year	Unamortized Patent Costs on Books	Book Amortization	Tax Amortization	(B-C) X 48%*	Unrecovered Tax Benefits Arising From Rapid Write- Off of Patents
Original Cost	\$17,000				
I	13,600	\$ 3,400	\$ 1,000	\$1,152	\$1,152
II	10,200	3,400	1,000	1,152	2,304
III	6,800	3,400	1,000	1,152	3,456
IV	3,400	3,400	1,000	1,152	4,608
V	-0-	3,400	1,000	1,152	5,760
VI	-0-	-0-	1,000	(480)	5,280
VII	-0-	-0-	1,000	(480)	4,800
.....	.....	.....	.....	.....	.....
XVI	-0-	-0-	1,000	(480)	480
XVII	-0-	-0-	1,000	(480)	-0-
TOTAL		\$17,000	\$17,000	-0-	-0-

\*Assuming taxable income in excess of \$25,000. If taxable income amounted to \$25,000 or less, then the benefit would actually be for only 22% rather than 48% as used here.

In addition, another entry would be made to record the "Unrecovered Tax Benefits Arising From Rapid Write-Off of Patents" for book purposes.

Unrecovered Tax Benefits Arising From Rapid Write-Off of Patents	\$1,152
Income Tax Expense Adjustment Arising From Rapid Write-Off of Patents	\$1,152

In Years VI-XVII, the following entry would be recorded:

Income Tax Expense Adjustment Arising From Rapid Write-Off of Patents	\$480
Unrecovered Tax Benefits Arising From Rapid Write-Off of Patents	\$480

In Years V-IV, the "Unrecovered Tax Benefits Arising From Rapid Write-Off of Patents" would be added to the unamortized patent costs on the balance sheet. In Years V-XVI, the unrecovered tax benefit would continue to be reported as an asset in the place of the patent. The question immediately arises as to whether such an account meets the test for an asset classification.

The test for assets. As outlined earlier, the first characteristic for an asset is that the item in question possess some expected future economic benefit. While the future service potential of the original outlay expires quite rapidly, the tax reducing benefit expires more slowly. Therefore, any firm which has an asset fully amortized for book purposes but not for tax purposes clearly has an unexpired future tax reducing benefit. In other words, it still possesses an asset.

The second test for assets is that the item under consideration must result from some current or past transaction. Obviously, this

test is met or the item would never be allowed as a tax deduction to any extent at any time. In the case of patents, the incurring of the patent expenditure gave rise to the tax reducing potential.

Achieves sound reporting. From a financial reporting standpoint, this suggested reporting methodology avoids the pitfall of considering two capitalized expenditures--exactly alike in amount and income characteristics--as having equal future value if only one of them can be deducted for tax purposes. Subsequent to the period of accelerated write-off for book purposes, the asset whose amortization was not accelerated for tax purposes has a greater value than one which was similarly acquired but amortized for tax purposes at a more rapid rate. This is potentially valuable information which accountants have too long neglected in their reporting practices.

As for the income statement, it may take the following form in Years I-V:

Net income before income taxes. . . . .	\$50,000
Provision for income taxes. . . . .	\$18,652
Income Tax Expense Adjustment Arising	
From Rapid Write-Off of Patents. . . . .	<u>1,152</u>
Income tax expense. . . . .	<u>17,500</u>
Net income after income taxes . . . . .	<u><u>\$32,500</u></u>

The \$18,652 would reflect the actual taxes payable for the year while \$17,500 would reflect the tax expense computed on accounting income. The statement reader would be informed of the tax charge per tax return--\$18,652--and at the same time still be able to relate the actual tax expense for the period to the accounting income.

Accounting Revenue Initially Exceeding Tax Revenue

In addition to the accelerated depreciation situations discussed earlier, a second class of circumstances which gives rise to the accounting income initially exceeding the taxable income is where revenue is recognized for accounting purposes but deferred for tax purposes. Two prime examples include: (1) long-term construction contracts where the percentage of completion basis is used for accounting purposes and (2) in the case of certain installment sales, where revenue is recognized in the period of sale for accounting purposes but deferred until the period of collection for tax purposes.

Under these circumstances, initially the accounting income exceeds the taxable income resulting in a deferred tax credit. The difference is not due to greater tax deductions as in the case of accelerated depreciation, but rather the variance springs from the initial revenue per income statement exceeding the revenue per tax return. For this reason, a deferred tax credit under these circumstances is altogether different from that of accelerated depreciation and consequently it, too, requires a unique analysis.

An illustration. To place the problem in perspective, assume the case of a construction contractor who, for accounting purposes, recognizes gross profit on a construction contract over a five-year period as presented in Column A of Table V.



TABLE V  
LONG-TERM CONSTRUCTION CONTRACTS -- AN ILLUSTRATION

	A	B	C	D	E
	Gross Profit Recognized For				
Year	Accounting Purposes	Tax Purposes	A-B	C X 48%*	Deferred Tax Credit
I	\$ 40,000	-0-	\$ 40,000	\$19,200	\$19,200
II	40,000	-0-	40,000	19,200	38,400
III	40,000	-0-	40,000	19,200	57,600
IV	40,000	-0-	40,000	19,200	76,800
V	40,000	\$200,000	(160,000)	(76,800)	-0-
TOTAL	\$200,000	\$200,000	-0-	-0-	

\*Assuming taxable income in excess of \$25,000. If taxable income amounted to \$25,000 or less, then the benefit would actually be for only 22% rather than 48% as used here.

Further assume that the contractor elects to postpone all gross income recognition for tax purposes; the election is made to include the gross profit in taxable income in the year of the contract completion, Year V. The differences in taxable income would be as presented in Column C and the tax consequences would be as reflected in Column D of Table V. Practicing interperiod tax allocation would result in an accumulation of a deferred tax credit in Years I-IV as shown in Column E. This account would be drawn down in Year V when taxable income catches up with accounting income leaving a zero balance in the tax deferral account.

Reporting methodology. Reflecting the results of interperiod tax allocation under the circumstances described above in the income statement could be accomplished as follows:

Net income before income taxes. . . . .	\$100,000
Provision for income taxes . . . . .	\$22,300
Income tax expense adjustment arising from deferment of revenue for tax purposes . . . . .	<u>19,200</u>
Income tax expense. . . . .	<u>41,500</u>
Net income after income taxes . . . . .	<u><u>\$ 58,500</u></u>

Once again, the total income tax deduction of \$41,500 can be related to the accounting income of \$100,000 while the \$22,300 figure can be easily traced to the taxable income of \$60,000.

The real reporting problem arises as to the proper reporting of the resulting tax deferred credit on the balance sheet for Years I-IV. Earlier sections of this study concluded that deferred tax credits fail the test for liabilities primarily because they do not represent any claim against the resources of the firm at the balance sheet date by the government. The only other alternative then is to offset the deferred tax credit against the related asset account, in this case, "Construction in Process," which represents the amount to be received from the customer in Year V.

The question now must be answered is such a suggested reporting practice first, sound from an accounting theory viewpoint and second, does such a reporting technique advance the utilitarian value of the balance sheet. From a theoretical standpoint, by offsetting the deferred tax credit, the reported asset value in connection with the construction venture is reduced. While the expected future economic

benefit to be received from the customer is represented by the "Construction in Process" account, to the extent that profit is realized, there must be a payment of taxes. Therefore, the total expected economic benefit to be received from the construction venture is not the amount receivable from the customer but the amount receivable after consideration of the tax consequences.

The value of reporting deferred tax credits of this nature as offsets<sup>21</sup> to the related asset account which gave rise to the tax deferral in the first instance is that it avoids the pretense that two assets of the same cost--exactly alike in physical and income characteristics--are of equal value if taxes have been paid on one but not the other. The asset on which the tax has not been paid has less value than the asset for which the tax has been paid. This factor would certainly be considered in any related managerial decision.

The conclusion of this analysis re-affirms the expense nature of the income tax charge. It was argued that in the case of (1) tax deductions exceeding accounting deductions, and (2) taxable income exceeding accounting income, the resulting deferred tax credit and debit were not liabilities and assets, respectively. This position in no way conflicts with the basic notion that the income tax is an expense. In fact, considering the tax consequences of a transaction

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<sup>21</sup>Under this suggested reporting treatment, probably it would be more appropriate to give the deferred tax credit some descriptive title such as "Accumulated Credit Arising From Deferment of Revenues for Tax Purposes."

as part and parcel of that transaction, as this study recommends, stresses with even greater emphasis the expense nature of the annual income tax charge.

In brief, the only treatment for deferred taxes which is consistent with existing accounting theory is to report such balances as contra accounts to the items which gave rise to the deferral in the first instance. The notion against offsetting assets and liabilities is not disturbed. Furthermore, such a treatment is far superior in achieving informative reporting in behalf of present and potential investors.

#### C. ACCOUNTING FOR CORPORATE INCOME TAX RATE CHANGES

Unfortunately, however, the contra account approach to reporting deferred taxes has not become generally used. The majority of accountants still report the deferred tax credit either as a "third" section on the right-hand side of the balance sheet or as a liability. For this reason, the analysis in the remainder of this chapter will consider the effect of corporate income tax rate changes on the financial statements if the deferred credit, liability, or contra classification is used for reporting tax deferrals.

#### The Selection of a Tax Rate

One of the major problems of implementing interperiod income tax allocation is the determination of the amount of the actual deferral. In other words, what tax rate should be employed in determining the tax effect of a difference in timing? As a guideline, the

Committee on Accounting Procedure has suggested that the appropriate rate may be the estimated future tax rate.

The estimated rate should be based upon normal and surtax rates in effect during the period covered by the income statement with such changes therein as can be reasonably anticipated at the time the estimate is made.<sup>22</sup>

The Committee's pronouncement, then, seems to call for currently accumulating the tax deferral based upon a 48 per cent tax rate (assuming that the corporation's expected future taxable income is in excess of \$25,000), the rate which can be reasonably anticipated at this writing.<sup>23</sup> This procedure would seem to be proper if the tax deferral is considered to be either an asset, liability, or contra account because in each instance the accountant is attempting to report the future tax effect.

On the other hand, if the tax deferral, say in the case of accelerated depreciation, is considered a "third" classification on the right-hand side of the balance sheet--a treatment incompatible with sound reporting--a case could possibly be made for accumulating

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<sup>22</sup>American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," Accounting Research Bulletin No. 43 (New York: American Institute of Accountants, 1953), p. 89. reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

<sup>23</sup>Here it is assumed that the allocation comes out of the "last" slice of income. Something can be said for using an "average" rate. A more complete discussion of a similar point is found in New Jersey Society of Certified Public Accountants, Committee on Accounting Principles and Practice, "Comment on 'Accounting for Income Taxes,'" The Journal of Accountancy, LXXIX (March, 1945), 238-239.

each year's deferral at the tax rate in effect for that year. Thus, in line with this interpretation, under the 1964 Revenue Act, the rate used should be 52 per cent for 1963, 50 per cent for 1964, and 48 per cent thereafter. In pointing out the reasoning behind this procedure, Paul Grady, who favors placing the deferred tax credit between liabilities and owners' equity, stated:

...the balance sheet account is regarded as a deferred credit, to be carried unadjusted until released to income when recorded depreciation exceeds tax depreciation. This approach contemplates that the release of amounts deferred is to be at the rate at which amounts previously entered the account, so that the effect of any difference in tax rates as between the year of provision and the year of release will be reflected in the latter year.<sup>24</sup>

Careful examination of this position, however, seems to call for treating the deferred tax credit as a retained earnings suspense item. Such a treatment, of course, is completely unsatisfactory.<sup>25</sup>

#### Adjustments for Tax Rate Changes

Another major problem associated with the practice of interperiod tax allocation is the determination of the proper adjustments, if any, to the deferred tax accounts when the tax rate changes from the level in effect at the time the accounts were accumulated. Many accountants have readily agreed that if the tax rates are not constant throughout

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<sup>24</sup>Paul Grady, "Tax Effect Accounting When Basic Federal Income Tax Rate Changes," The Journal of Accountancy, CXVII (April, 1964), 26.

<sup>25</sup>For an illustration of the workings of Grady's recommendation, see infra, pp. 137-139.

the period of allocation, then a correction is clearly in order.<sup>26</sup> Such an observation is in harmony with the analysis of the economic nature of the corporate income tax charge as presented earlier in this study.

Because corporate income tax rates have remained unchanged since income tax allocation has become widely practiced, accountants have never had the occasion to accompany their observations--that adjustments should be made when there is a change in the tax rate--with any specific recommendations as to the nature of such corrections. With the passage of the 1964 Revenue Act, accountants can no longer continue to ignore the form of the tax deferral adjustments. As of this writing, however, with one single exception, no suggestions have been forthcoming from accountants.

The one exception was Paul Grady, who even though Director of Accounting Research for the AICPA, issued a "statement on his own responsibility" in April, 1964.<sup>27</sup> Grady felt that there were two generally practiced "theories" of tax allocation: (1) consider the tax deferral as a non-liability on the right-hand side of the balance sheet, or (2) regard the tax deferral as an estimated liability. If the deferral is considered a deferred credit outside the liability classification, as Grady recommended, he suggested the following procedure when there is a change in income tax rates.

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<sup>26</sup>Maurice Moonitz, "Income Taxes in Financial Statements," The Accounting Review, XXXII (April, 1957), 179 and Sands, op. cit., p. 590.

<sup>27</sup>Grady, op. cit., pp. 25-27.

The accumulation at any point in time of the amounts of current tax reduction provided for previously should be allocated to future periods at the same rate that the amounts were accumulated in the account...<sup>28</sup>

In other words, the entries reducing the tax deferred account would be the same as if no tax rate change had occurred.

An illustration. To illustrate the procedures involved, assume that a depreciable fixed asset was purchased at the beginning of 1961 and sum-of-the-years' digits method of depreciation is used for tax purposes while straight-line is utilized for financial accounting purposes. Assuming no salvage value, and a ten year life, the annual depreciation would be as presented in Columns A and B, respectively, of Table VI. Column C reflects the difference in book depreciation and tax depreciation. Assuming that the company's taxable income is in excess of \$25,000 for each year of asset depreciation, and that the tax rate applied to such income is 52 per cent, then, the increases (first five years) and decreases (last five years) to the deferred tax account would be as presented in Column D.

The tax deferral as a non-liability. Grady stated that if the deferred tax account was considered a non-liability, then no adjustment at the time of the tax change was in order. For any additional accumulation, the new rates should be used. This procedure is depicted in Column F of Table VI. Accumulations for 1961-63 were made using the prevailing 52 per cent tax rate, for 1964 a 50 per cent tax rate was applied, and for 1965, the last year of accumulation, a

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<sup>28</sup>Ibid., p. 27.



TABLE VI

## ACCOUNTING FOR TAX RATE CHANGE -- AN ILLUSTRATION

	A	B	C	D	E	F
				Entries to Tax Deferral Account		
				Constant Tax Rate	If Tax Rate Changes*	
End of Year	Tax Depreciation	Book Depreciation	A-B	C X 52%	Liability or Contra	Deferred Credit
1961	\$10,000	\$ 5,500	\$ 4,500	\$ 2,340	\$ 2,340	\$ 2,340
1962	9,000	5,500	3,500	1,820	1,820	1,820
1963	8,000	5,500	2,500	1,300	1,300	1,300
1964	7,000	5,500	1,500	780	720	750
1965	6,000	5,500	500	260	240	240
1966	5,000	5,500	(500)	(260)	(240)	(240)
1967	4,000	5,500	(1,500)	(780)	(720)	(750)
1968	3,000	5,500	(2,500)	(1,300)	(1,200)	(1,300)
1969	2,000	5,500	(3,500)	(1,820)	(1,680)	(1,820)
1970	1,000	5,500	(4,500)	(2,340)	(2,160)	(2,340)
TOTAL	\$55,000	\$55,000	-0-	-0-		-0-
Amount of Adjustment in 1964					\$ 420	

\*Tax Rate:

1961-63: 52%

1964: 50%

1965-70: 48%

rate of 48 per cent was employed. In 1966, the tax deferral must begin to decrease. Grady wrote that the rates to be used for drawing down the tax deferral were to be the same as employed in building up the account. It seems that Grady had in mind, although he did not illustrate, the procedure as employed for 1966-1970, presented in Column F of Table VI. Carrying this suggestion to its logical conclusion, it would mean charging \$2,340, the amount of the tax deferral accumulated in 1961 when the 52 per cent tax rate was in effect, against revenue of 1970 when a 48 per cent rate was applicable. In other words, the charges against revenue would be the same as if the tax rate never changed (compare Column F with Column D for year 1970). Clearly such a procedure does not reflect economic reality, to say nothing of the complications associated with its practical application.

Grady did offer one alternative for recording the reduction to the deferral tax account. He suggested that an average rate be used, but he did not offer any further comment. One can only speculate whether he had in mind a weighted average rate and the techniques he would use.

The tax deferral as a liability or contra account. If the practicing accountant reports the tax deferral as a liability or as a contra account with the 1964 Revenue Act tax rate reductions of 1964 to 50 per cent and 1965 to 48 per cent, then in 1964, an adjustment should be made (see Column E of Table VI) to the deferred tax account on the basis of the 48 per cent rate--the rate which is

expected to remain in effect in the foreseeable future. The adjustment would be as follows in 1964:

Deferred income tax liability (or contra account)	\$420
Correction of deferred taxes due to rate change (or retained earnings)	\$420

The amount of the adjustment would be the balance of the deferral account after the asset is fully depreciated--after 1970 in the illustration. The amount of the adjustment, however, can easily be determined from the accounting records without having to prepare a special schedule for the asset's expected remaining life as presented in Table VI. This could be done by dividing the balance of the deferred tax account at the date of the tax adjustment by the tax rate used to accumulate the deferred account (the rate in effect to date of change) and multiplying the result by the amount of the tax rate change. For instance, letting:

TA = amount of tax adjustment

B = balance of deferred tax account at time of adjustment

TR' = tax rate in effect to accumulate deferred tax

TR'' = anticipated future tax rate

$$\Delta TR = TR' - TR''$$

using the data from Table VI:

$$B = \$2340 + \$1820 + \$1300 = \$5460$$

$$TR' = 52\%$$

$$TR'' = 48\%$$

$$\Delta TR = 52\% - 48\% = 4\%$$

and letting:

$$TA = \frac{B (\Delta TR)}{TR'}$$

then:

$$TA = \frac{\$5460 (.04)}{.52}$$

or:

$$TA = \$420$$

The above analysis was presented in terms of a tax deferral with a credit balance and with a tax rate decrease. The accounting treatment for a deferred tax debit with a rate increase would be similar. On the other hand, a deferred tax debit with a tax rate decrease or a deferred tax credit with a tax rate increase would require crediting the tax deferral account and debiting an account to correct profits of prior periods. One accountant has stated that in making the adjusting entries, there should be required, on the grounds of conservatism, more substantial evidence to increase the retained earnings account (crediting a "correction" account).<sup>29</sup> Be that as it may, if the amount involved is material, and the tax rate is expected to remain at its new or lower level (in the case of an initial decrease), then clearly an adjustment is necessitated.

#### Changes in Profit Levels

Another problem facing accountants in practicing tax allocation is the difficulty which arises when the taxes ultimately payable

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<sup>29</sup>Sands, op. cit., p. 590.

become different from the taxes estimated at the time the deferral was recognized because profit levels changed in the meantime causing different tax rates to be applicable. For example, if the taxable income was below \$25,000 for 1964, the applicable tax rate was 22 per cent. Then if the corporation's taxable income is in excess of \$25,000, it is subject to the surtax (28 per cent for 1965 and thereafter).

As a practical solution to this problem, and to avoid continued adjustments to the tax deferral account, this writer suggests the same policies be employed as outlined above for tax rate changes. That is, if the new income level is expected to prevail into the foreseeable future (e.g., a new and growing company) which passes the \$25,000 mark in its first few years, then an adjustment should be made for the new applicable tax rate. If there was too much uncertainty as to the future profit level of the firm, then it seems appropriate not to record an adjustment.

#### Asset Disposition

There is still one other problem in need of attention in connection with the practice of interperiod income tax allocation. It is the question of the proper disposition of the deferred tax account when the item which gave rise to the deferral, say equipment, is disposed of before the tax deferral has balanced out.

This problem is easily resolved when the two-fold value (or in the case of a liability, two-fold obligation) of the asset is considered:

(1) its service potential, and (2) its tax reducing value. Since accountants record the expiration of the service potential via depreciation, it follows that the tax reducing potential of the asset should be handled in the same manner. In other words, the tax deferral should be written off by recognizing a gain from owning an asset which provided a firm with an opportunity to reduce its taxes during the period of its ownership.

To illustrate, assume that the asset depicted in Table VI is disposed of at the beginning of 1964. At this point, the tax deferral account would have a balance of \$5,460, and accumulated depreciation of \$16,500 on the books. Assuming that the asset is sold for \$40,000 cash and its original cost was \$55,000, the entry to record the disposition would be, if the contra account was used, as follows:

Accumulated deductions caused by rapid write-off	\$ 5,460	
Accumulated depreciation	16,500	
Cash	40,000	
Equipment		\$55,000
Gain on disposal of fixed assets		6,960

The "unexpired" tax reduction benefit of the asset serves to increase the gain or reduce the loss, as the case may be, upon early disposition of the related asset.

#### D. SUMMARY

Several problems arise in the implementation of interperiod income tax allocation. One of these is the proper classification of the tax deferral accounts. Several alternatives for classifying tax deferrals have been offered by the advocates of interperiod

allocation. These alternatives include considering the deferral (1) as a part of owners' equity, (2) as a "third" classification on the right-hand side of the balance sheet between liabilities and owners' equity, (3) as a liability, in the case of credit balances, and (4) as an asset, in the case of debit balances. None of these proposals, however, are consistent with existing accounting theory.

This study proposed presenting tax deferrals as "offsets" or contra accounts to the balance sheet item which gave rise to the deferral in the first instance. Such a treatment is not only consistent with existing accounting theory, but also results in more informative financial reporting than heretofore has generally been practiced.

In addition to solving the classification dilemma for the tax deferral, practitioners of interperiod tax allocation must also devise appropriate procedures for accounting for changes in the corporate income tax rates. This is a problem of recent origin to which the solution is rather clear-cut.

## CHAPTER VI

### ACCOUNTING FOR THE INVESTMENT CREDIT AND NET OPERATING LOSS CARRYBACKS AND CARRYOVERS

Closely related to the problem of interperiod tax allocation discussed in Chapter V is the problem of timing for financial reporting purposes the newly inaugurated investment tax credit and the benefits of net operating loss carrybacks and carryovers.

A great deal of confusion presently surrounds the proper accounting methodology for the investment credit. Essentially the problem is whether the entire investment credit should be reflected in the income statement in the year of the asset acquisition or should it be spread over the productive life of the asset. In connection with operating loss carrybacks and carryovers, the problem is whether the benefit should be recognized in the year of the loss, the year when realized, or in some other period. These are the basic problems considered in this chapter.

#### A. THE INVESTMENT TAX CREDIT

##### Background

The Revenue Act of 1962 sought to encourage investment in productive facilities by permitting taxpayers to reduce their federal income taxes by a specified percentage of the cost of certain



depreciable properties acquired after January 1, 1962. This reduction is known as the investment tax credit.

More specifically, the investment credit provided that the taxpayer could deduct up to 7 per cent, with certain limitations, of the cost of tangible personal property acquisitions that had an estimated life of 8 or more years. Reduced credits were allowed for property with a useful life of more than 4 years, but less than 8 years.

The basis of the property qualifying for the investment credit also had to be reduced for future depreciation purposes by the amount of the related investment credit. The Revenue Act of 1964 eliminated this latter requirement of the 1962 Act, however. Simply stated, all that is required of the taxpayer under the present law is to multiply the appropriate percentage times the cost of the qualifying asset and deduct the result from his income taxes that would otherwise be payable.<sup>1</sup>

Basically there are two viewpoints concerning the appropriate accounting treatment of the allowable deduction or investment tax credit. One viewpoint holds that the entire investment credit should be recognized as a tax expense reduction in the year of the asset's acquisition. A contrary viewpoint maintains that the investment credit benefit should be spread over the expected useful life of the acquired facility.

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<sup>1</sup>The currently prevailing applicable rules are detailed in the Internal Revenue Code of 1954 (as amended February, 1964) Sec. 38, 46-48.

For purposes of illustration, assume the acquisition of a fully qualified piece of equipment in 1965 for \$100,000. The equipment has an estimated useful life of 10 years. Assume further that the taxable income and accounting income without regard to the investment credit amount to \$90,000 with 1965 income tax rates in effect.

As A Tax Expense Reduction

If the entire amount of the investment credit ( $7\% \times \$100,000 = \$7,000$ ) was considered to be a reduction in the income tax expense in the year of the asset acquisition, the following entry would be recorded (assuming the regular tax accrual entry was made):

Income Taxes Payable	\$7,000
Income Tax Expense Adjustment Arising From the Investment Tax Credit	\$7,000

The last section of the income statement, even under the current operating performance concept, would be presented as follows:

Net income before income taxes . . . . .	\$90,000
Income tax expense . . . . .	\$36,700
Less: Income tax expense adjustment arising from the investment tax credit . . . . .	<u>7,000</u>
Provision for income taxes . . . . .	<u>29,700</u>
Net income after income taxes . . . . .	<u>\$60,300</u>

If the investment credit is considered to be an income tax reduction in full in the year of the asset purchase, then in subsequent periods no further adjustments in connection with the investment credit would be required.

### Spreading the Credit Over the Life of the Asset

Instead of recognizing the entire investment credit as a reduction of income tax expense in the year of the asset acquisition, the contrary viewpoint holds that the credit should be spread over the life of the asset. One possible set of entries to implement this proposal would be as follows:

- |     |                                       |          |          |
|-----|---------------------------------------|----------|----------|
| (1) | Income Tax Expense                    | \$36,700 |          |
|     | Income Tax Payable                    |          | \$36,700 |
|     | To record the tax accrual             |          |          |
| (2) | Income Taxes Payable                  | 7,000    |          |
|     | Unamortized Investment Tax Credit     |          | 7,000    |
|     | To recognize the investment credit    |          |          |
| (3) | Unamortized Investment Tax Credit     | 700      |          |
|     | Amortization of Investment Tax Credit |          | 700      |
|     | To recognize the portion of the       |          |          |
|     | investment credit applicable to 1965  |          |          |

Entry (3) would be repeated each year until the disposal of the account or the asset, whichever occurs first. The income statement in 1965, with similar presentation in later years, would appear as follows:

Net income before income taxes . . . . .	\$90,000
Income tax expense . . . . .	\$36,700
Less: Amortization of investment	
tax credit . . . . .	<u>700</u>
Provision for income taxes . . . . .	<u>36,000</u>
Net income after income taxes . . . . .	<u><u>\$54,000</u></u>

Reporting the investment credit in the balance sheet. The question now to be answered is how shall the "Unamortized Investment Tax Credit" be reported in the balance sheet? In answering this question, the issue can also be resolved as to which method--recognizing the entire investment credit as a tax reduction in the year of the

related asset acquisition or spreading it over the life of the asset--is the more theoretically sound and yet consistent with useful financial reporting.

First, the same argument presented earlier for not classifying the deferred tax credit as a liability, in the case of accelerated depreciation, holds true even more so for the deferred investment tax credit. In short, there is no claim against the firm by the federal government as of the balance sheet date for the amount of the deferred investment credit. Clearly this is not an item which will require the conveyance of assets or performance of services at anytime in the future. The liability test is not met.

Values acquired with the purchase of an asset. At this point it will be well to recall the purpose for which management acquired the asset in the first place. As pointed out earlier, there are two values purchased by management when an asset is acquired: (1) a bundle of services, called service potentials, and (2) a tax reducing benefit. The accounting treatment of each of these purchased values has already been presented. In the case of assets which qualify for the special investment tax credit, a third benefit is acquired--the right to reduce tax payments by as much as 7 per cent, computed independently of the investment credit.

It is well recognized as sound accounting theory to match the service potential of the asset against the revenue it was acquired to produce, i.e., spread the cost of the asset over its useful life. An analogous situation holds true for the investment credit. As the

Accounting Principles Board concluded, in supporting their recommendation to spread the investment credit over the asset's productive life, "Earnings arise from the use of facilities, not from their acquisition."<sup>2</sup>

As Berg and Mueller stated:

. . . one could argue that the purchase of equipment is participating in an equipment modernization program and earns the investment credit by purchasing qualified equipment and retaining it for the required number of years. At the end of the required holding period the investment credit is no longer subject to recapture. Therefore, it would not seem appropriate to permit it to affect the income determination of subsequent periods.<sup>3</sup>

Inasmuch as the investment credit certainly plays a role in management's decision concerning the asset acquisition it only seems logical that the unamortized investment credit benefit should be related to the asset which gave rise to the investment credit in the first instance. In short, the unamortized investment credit should serve to reduce the asset basis on the balance sheet. Thus, while the contractual cost is still reported, the final effect is to reflect the "net" cost--net of the investment credit--to the firm.

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<sup>2</sup>American Institute of Certified Public Accountants, Accounting Principles Board, "Accounting for the 'Investment Credit,'" Opinions of the Accounting Principles Board No. 2 (New York: American Institute of Certified Public Accountants, 1962), p. 7. Subsequently when there was not widespread adoption of the Board's recommendation, the Board announced as an acceptable alternative the method of treating the credit as a reduction of income taxes of the year in which the credit arises. See American Institute of Certified Public Accountants, Accounting Principles Board, "Accounting for the 'Investment Credit,'" Opinions of the Accounting Principles Board No. 4 (Amending No. 2) (New York: American Institute of Certified Public Accountants, 1964).

<sup>3</sup>Kenneth B. Berg and Fred J. Mueller, "Accounting for Investment Credit," The Accounting Review, XXXVIII (July, 1963), 560.

Viewed differently, the benefit derived from the investment credit is realized in the period of the asset's acquisition. Therefore, by deducting the realized investment credit, the remaining future economic benefit of the equipment is reported. For income reporting, however, this "purchased" benefit should be matched ~~periodically~~ against the revenue in accordance with the matching concept. The amortization of the investment credit, then, should coincide with the useful life of the asset. That is, when the asset no longer generates the revenue it was purchased to produce, the investment credit should be fully amortized at that point.

#### B. ACCOUNTING FOR NET OPERATING LOSS CARRYBACKS AND CARRYOVERS

The problem of properly reporting in general, all-purpose financial statements the tax consequences of net operating loss carrybacks and carryovers has not received consideration commensurate with its importance. In practically every case where net operating losses are incurred, the tax consequences have a very material impact upon the reported financial results for a period of several years. Unlike interperiod tax allocation and the investment credit, however, accountants have not given due consideration to the accounting problems of how the tax reductions arising from the carryback and carryover should be best treated in financial reporting.

### Code Provisions

For accounting purposes, except for the attendant tax consequences, a net operating loss of one period has no effect upon the reported operating results of periods before or after the loss arose; each year stands on its own. Provisions in the tax law, however, result in the likelihood of a net operating loss of one period affecting the reported taxable earnings of other periods. The applicable excerpts from the Internal Revenue Code are as follows:

#### Sec. 172. Net Operating Loss Deduction

- (a) Deduction Allowed.--There shall be as a deduction for the taxable year an amount equal to the aggregate of
  - (1) the net operating loss carryovers to such year, plus, (2) the net operating loss carrybacks to such years.
- (b) Net Operating Loss Carrybacks and Carryovers.--
  - (1) Years to which loss may be carried.--
    - (A) . . . a net operating loss for any taxable year ending after December 31, 1957, shall be a net operating loss carryback to each of the 3 taxable years preceding the taxable year of such loss.
    - (B) . . . a net operating loss for any taxable year ending after December 31, 1955, shall be a net operating loss carryover to each of the 5 taxable years following the taxable year of such loss . . . .
  - (2) Amount of carrybacks and carryovers.--Except as provided in subsection (i) and (j), the entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable year shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried.<sup>4</sup>

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<sup>4</sup>Internal Revenue Code of 1954 (as amended February, 1964), Sec. 172 (a) (b).

The law thus allows, with selected exceptions,<sup>5</sup> a net operating loss to be carried back to each of the three preceding years and carried forward to each of the following five years. The loss is applied to the earliest year first.

#### An Illustration

To illustrate the procedures involved, assume a taxable income pattern as reported in the first amount column of Table VII.

TABLE VII  
LOSS CARRYBACKS AND CARRYOVERS -- AN ILLUSTRATION

Year	Taxable Income	Related Income Taxes*	Amount of 19x4 Loss Applied	Taxable Income After Applying Loss	Unapplied Net Operating Loss
19x1	\$ 30,000	\$ 7,900	\$30,000	-0-	\$320,000
19x2	40,000	12,700	40,000	-0-	\$290,000
19x3	30,000	7,900	30,000	-0-	250,000
19x4	(320,000)	-0-	-----	-0-	220,000
19x5	30,000	7,900	30,000	-0-	-----
19x6	40,000	12,700	40,000	-0-	190,000
19x7	50,000	17,500	50,000	-0-	150,000
19x8	60,000	22,300	60,000	-0-	100,000
19x9	70,000	27,100	40,000	\$30,000	40,000
					-0-

\*Tax rate: First \$25,000 of taxable income, 22%  
Above \$25,000 of taxable income, 48%

\*\*Tax benefit in 19x9 is \$19,200 (48% x \$40,000).

After filing its 19x4 return, the company exemplified in Table VII can file a refund claim for the taxes paid in 19x1, 19x2 and 19x3

<sup>5</sup>See Ibid., Sec. 172 (b) (1) (A) (ii) and 172 (b) (1) (C) (D).



totaling \$28,500. In addition, of course, the unused net operating loss can be carried forward to reduce any reported taxable income of the subsequent five years--subsequent to 19x4, the year of the loss. The basic purpose of section 172 of the Internal Revenue Code is an attempt to insure that no more than the total income throughout the life of an enterprise is taxed. The three and five year limits are imposed for practical reasons in administering the law. Clearly, then, net operating loss provisions of the tax law benefit an enterprise by (1) providing for a recovery of taxes paid in preceding years, and, if not used up, (2) in providing for a reduction in taxes to be paid in subsequent years. Accordingly, the carryback and the carryover each pose different and unique accounting and financial reporting problems.

#### Accounting for Loss Carrybacks

In the period when a net operating loss is incurred, of course, there is no income tax accrual for that year. Under the loss carryback provisions of the Code, however, if taxes were paid during the preceding three-year period, the enterprise files an amended return and claims a refund.

The theory. From a financial reporting standpoint, the tax reductions arising from the carryback should be shown in the income statement for the period in which the loss occurs. This procedure is in harmony with the basic concept of matching, i.e., associating the credit with the costs that gave rise to the loss. In other words, there was some benefit, after all, from having a loss. For this reason, the loss carryback should not be reflected as an adjustment of

earnings of previous years via retained earnings. The tax reducing benefit should be reflected in the accounts by the following entry (based on data in Table VII).

Claim for Federal Income Tax Refund	\$28,500
Income Tax Credit Arising From	
Carryback of Operating Loss	\$28,500

The "Claim for Federal Income Tax Refund" should be included generally in the balance sheet as a current asset.

Acceptance. The procedure described above for reporting net operating loss carrybacks has gained general acceptance<sup>6</sup> and is supported at the time of this writing by the American Institute of Certified Public Accountants in Accounting Research Bulletin No. 43.

While claims for refund of income taxes ordinarily should not be included in the accounts prior to approval by the taxing authorities, a claim based on the carryback provisions of the Internal Revenue Code presumably has as definite a basis as has the computation of income taxes paid in prior years which are refundable to the taxpayer as the result of the carryback of losses or unused excess-profit credits ordinarily should be included in the income statement of the year in which the loss occurs or the unused excess-profits credit arises.<sup>7</sup>

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<sup>6</sup>See American Institute of Certified Public Accountants, Accounting Trends & Techniques--1963 (seventeenth edition; New York: American Institute of Certified Public Accountants, 1963), p. 59.

<sup>7</sup>American Institute of Accountants, Committee on Accounting Procedure, "Restatement and Revision of Accounting Research Bulletins," Accounting Research Bulletin No. 43 (New York: American Institute of Accountants, 1953), p. 91 reprinted in American Institute of Certified Public Accountants, Accounting Research and Terminology Bulletins (final edition; New York: American Institute of Certified Public Accountants, 1961).

While there is general agreement concerning the accounting treatment of loss carrybacks, the same cannot be said for the other side of the coin--loss carryovers--which are discussed next.

#### Net Operating Loss Carryovers

Basically, there are two prevailing points of view, which are diametrically opposite, concerning the proper accounting treatment of loss carryover tax benefits.

Reflection of the benefit in the year of realization. One point of view holds that "the tax reduction should be reflected in the year when realized."<sup>8</sup> This position has the support of Accounting Research Bulletin No. 43 which states:

. . . where taxpayers are permitted to carry forward losses or unused excess-profits credits, the committee believes that . . . the resulting tax reduction should be reflected in the year to which such losses or unused credits are carried.<sup>9</sup>

The viewpoint that the tax reduction should be reflected in the year when realized--in Table VII this would be 19x5-19x9--is acclaimed to be based upon sound accounting theory. Two factors are said to be responsible for providing a tax reduction as a result of a loss carry-over: (1) a prior year loss; and (2) a profit in a subsequent year.

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<sup>8</sup>James C. Van Horne, "A Look at the Loss Carry-Forward," The Accounting Review, XXXVIII (January, 1963), 60.

<sup>9</sup>American Institute of Accountants, loc. cit. This position is also endorsed by the Canadian Institute of Chartered Accountants, Committee on Accounting and Auditing Research, "Loss-Carry-Over Tax Credits," Accounting and Practice Bulletin No. 12 (Toronto: The Canadian Institute of Chartered Accountants, 1956).

Both of these factors must be present before a benefit accrues to the enterprise from a loss carryover sometimes called carryforward. Since the loss comes first, then the determining factor is whether or not profitable years follow. If profitable years do not follow, then no benefit ever accrues to the company, unless of course, the company is merged with a profitable concern. Conversely, if profitable years do follow, then a benefit to the enterprise results. As Van Horne concluded:

Thus, the realization of the carryforward is directly related to the profitable year, when the carryforward is utilized. The amount of profit determines what portion of the carryforward will be applied to reduce taxes. The actual tax benefit, when cash is conserved, is in the year of realization, not in the year of the loss.<sup>10</sup>

The 1964 Income Statement of the Cudahy Packing Company, presented in Exhibit 7, provides an excellent example of the application of this viewpoint.

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<sup>10</sup>Van Horne, loc. cit.

## EXHIBIT 7

THE CUDAHY PACKING COMPANY AND SUBSIDIARIES<sup>11</sup>  
 Consolidated Income Statement  
 For the Fiscal Year Ended October 31, 1964

Line No.		
1	Net Sales and Operation Revenue	<u>\$329,604,252</u>
2	Cost and Expenses:	
3	Cost of products, supplies & services	\$308,190,707
4	Selling and administrative	13,679,966
5	Provision for depreciation	1,733,461
6	Taxes, other than Federal income taxes	2,528,877
7	Interest	873,363
8	Pension costs	844,219
9	Provisions for Federal income taxes (See Note)	-
10		<u>\$327,850,593</u>
11	Net Income For the Year, including the elimination of Federal income taxes of \$875,000 (see note)	<u>\$ 1,753,659</u>

NOTE: By reason of prior years' losses, Federal income taxes for 1964 were eliminated. Net income for 1964 after Federal income taxes computed without benefit of loss carry-forwards amount to \$878,659. Substantial loss carry-forwards are available for tax purposes in future years.

Reflection of the benefit in the year of loss. There is strong sentiment, however, for an opposing position--one which holds that the tax reduction from the carryover credit does not belong in the subsequent year of realization, but in the year in which the loss occurred. For example, consider the remarks of George O. May who wrote:

In an extreme case, for the purposes of an income tax, which makes no distinction between losses relating to the current and past years, a charge growing out of the

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<sup>11</sup>The Cudahy Packing Company, Annual Report, 1964, p. 14.

past may offset the profits of the present so that no tax is payable. In such a case, a figure of net income for the year without any deduction for tax is almost bound to be misleading. It is not an adequate answer to say that the danger of misunderstanding may be mitigated by an explanatory note. Footnotes are, at best, unsatisfactory, and in this instance whatever can be done in a note can be done in a way that will be more helpful to the inexperienced reader in the presentation of the statement itself.<sup>12</sup>

May was of the opinion that the underlying purpose of financial statements would best be achieved by reporting an income tax expense in the income statement in the year of the carryover without regard to the tax reduction due to the carryover. This procedure would call for carrying the tax reduction directly to retained earnings,<sup>13</sup> which is basic to the current operating performance type of reporting. To achieve this result, the following entry would be recorded for 19x5 (using the data in Table VII).

Income Tax Expense	\$7,900	
Retained Earnings		\$7,900

An example of carrying the tax reduction to retained earnings in the year of the carryover is explained in the notes to 1963 financial statements of Freeport Sulphur Company.

NOTE 3: The Company has a substantial unused tax-loss carryforward available to it at the end of 1963 and will continue to charge income and credit retained earnings with the appropriate portion of tax savings as they are realized.<sup>14</sup>

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<sup>12</sup>George O. May, Financial Accounting (New York: The Macmillan Company, 1943), p. 235.

<sup>13</sup>Ibid., p. 238.

<sup>14</sup>Freeport Sulphur Company, Annual Report, 1963, p. 20.

Theoretical rationale. In supporting the viewpoint described above, May stated:

It may be argued that suffering a loss does not create a right to refund of tax, and that it is the making of a profit that gives effectiveness to the relief provision. And as already noted, there is considerable accounting objection to the charging against income of tax that has not actually been paid. But these arguments do not seem to weigh heavily in the scale against the consideration that to charge only the net tax against income would give a false impression of the result of the year's operations and also of the relation between the corporation's profits and its financial contribution . . . in the form of taxes.<sup>15</sup>

Like the opposite viewpoint, recognizing the tax reduction benefit of the loss carryover in the year the loss occurred is also said to be supportable on grounds of achieving a proper matching of costs and revenues.

To the extent that operating losses are sustained for income-tax purposes, the 52 (now 48) cents per dollar (based on current normal and surtax rates) of cost charged to income is not recovered by tax reductions in that year. But there is a possibility of recovery through the five-year carry-forward of the operating losses. Since any such realization represents recovery of costs recognized in the loss year, the tax benefit should be applied in that year. Otherwise, not only would the net loss of that year be overstated, but the net income of the other year(s) to which the loss was carried would be overstated because of the tax reduction attributable to costs that were recognized in the loss year.

Thus, a proper matching of costs and revenues requires that the income tax reduction from the carry-forward of operating losses be related to the years in which the losses occurred.<sup>16</sup>

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<sup>15</sup>May, op. cit., p. 238.

<sup>16</sup>Arthur Andersen & Co., Accounting and Reporting Problems of the Accounting Profession (second edition; Chicago: Arthur Andersen & Co., 1962), p. 55.

A compromise between reporting net income without regard to the loss carryover and in the reporting of a net income figure giving effect to the tax reducing benefit can be devised. Using the Income Statement of the Cudahy Packing Company presented in Exhibit 7 as an example, Federal income taxes of \$875,000 could be deducted in line 9 and then added back after line 11. The result of this adjustment would be that line 11 would reflect a net income figure without regard to the tax reduction and yet the final amount would reflect an earnings figure giving effect to the tax reduction. In effect, the all-inclusive type of income statement is presented under this arrangement.

#### Tax Loss Carryovers as Assets--A Proposal

At this point the question should be carefully examined as to whether either of the viewpoints discussed above for accounting for tax loss carryovers (1) are indeed well founded after all in sound accounting theory as claimed; and (2) is the utilitarian value for external users of financial reporting best served by either approach.

For example, in a footnote to the 1963 financial statements, Eastern Air Lines, Inc. reported that:

Because of the carry forward provisions of the Internal Revenue Code, there is available for deduction against future income which would otherwise require provisions for federal income tax the net amount of approximately \$45,000,000 resulting from losses of this and prior years.<sup>17</sup>

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<sup>17</sup>Eastern Air Lines, Inc., Annual Report, 1963, p. 19.



At this same time, Eastern's stockholders' equity amounted to only \$49,067,972.<sup>18</sup>

Clearly, to Eastern Air Lines, Inc., this \$45,000,000 operating loss carryover is possibly the most important single potential future economic benefit it has. The operating loss carryover is almost as large as the total stockholders' equity; therefore, the resulting tax benefit would be approximately one-half of this amount. Accounting practice (and accounting theory has acquiesced) has relegated such a significant future economic benefit to a mere footnote notation and even then, in many cases, never giving an inkling of the magnitude of the future tax reducing benefit.<sup>19</sup>

The theoretical aspects. From an accounting theory standpoint, the solution seems clear. If the operating loss carryover represents an expected future economic benefit--and in only very rare cases would management expect not to earn a profit within the next five years--then it meets the first test for an asset classification. The carryover is a benefit which stems from the fact that it preserves valuable cash which otherwise would have to be paid out in taxes. This benefit is valuable to the enterprise's stockholders, whether they continue to operate ~~the~~ firm or sell it.<sup>20</sup>

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<sup>18</sup>Ibid., p. 17.

<sup>19</sup>For example, see Freeport Sulphur Company, Annual Report, 1963, p. 20 and The Cudahy Packing Company, Annual Report, 1964, p. 14.

<sup>20</sup>See Robert S. Holzman, "Who Wants a Tax Loss?" The Controller, XX (October, 1952), 563-564.

The second test for an asset, it will be recalled, is that the item in question must have been acquired by the enterprise as a result of some current or past transaction. Loss carryovers arise as a result of excessive (relative to revenue) expenditures of the current period or of past periods as represented, for example, by depreciation and amortization. As long as they are expected to result in a tax reduction benefit, the asset test is met for loss carryovers.

More effective financial reporting. In addition to being sound accounting theory, reporting the loss carryover as an asset provides more effective financial reporting than tucking the tax reduction away in a footnote which may not be read or clearly understood. To again quote George O. May:

Footnotes are, at best, unsatisfactory, and in this instance whatever can be done in a note can be done in a way that will be more helpful to the inexperienced reader in the presentation of the statement itself.<sup>21</sup>

In brief, classifying the carryover as an asset minimizes the possibility of this expected future valuable economic benefit escaping the attention of the financial statement user.

The argument may be raised that the loss carryover is strictly a contingent asset--contingent upon the earning of profits. This argument is readily resolved by recalling first, the assumption that the basic objective of the firm is to earn profits, and second, the accounting assumption of the going concern. These are the basic premises of asset accounting in general.

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<sup>21</sup>May, op. cit., p. 235.

If it becomes evident that the firm will not have taxable income against which it can apply the loss carryover, i.e., that the tax reduction benefit is decreased or will not materialize, just as for any other asset, a loss should be recognized at that time, but not before.

The portion of the tax loss carryover benefit which is expected to be realized in the next fiscal year or operating cycle should be classified as a current asset. The remainder should be reported as an intangible asset.

Recording techniques. At this point, it should be clarifying to describe the entries which would accomplish the procedures explained above for considering the carryover as an asset. For illustration purposes, assume that a corporation's management realistically forecasts taxable income of at least \$25,000 before applying the loss carryover for the entire five-year period following the year of the loss. Further assume that the loss carryover is not fully used up until the end of the fifth year. Naturally a change in either of these assumptions will affect the actual amount of the tax-reducing benefit of the loss carryover.

Under these assumptions then, using the data presented in Table VII, the entry in 19x4 would be:<sup>22</sup>

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<sup>22</sup>This entry in 19x4 would be accompanied by another entry, it will be remembered (supra, p.155), recognizing the loss carryback as follows:

Claim for Federal Income Tax Refund	\$28,500	
Income Tax Credit Arising From		
Carryback of Operating Loss		\$28,500

Future Tax Benefits Arising From Loss Carryovers	\$79,600
Income Tax Credit Arising From Carryover of Operating Loss	\$79,600

Then in 19x5, the routine tax accrual entry to record the income tax expense and the corresponding income tax liability would be booked as follows:

Income Tax Expense	\$7,900
Estimated Income Taxes Payable	\$7,900

In addition, as a result of the loss carryover the following entry would be made in 19x5:

Estimated Income Taxes Payable	\$7,900
Future Tax Benefits Arising From Loss Carryover	\$7,900

If in 19x4, the year of the operating loss, there is reason to believe that due to the existing circumstances and plans for future operations the enterprise will not be in a position to utilize the full benefits of the entire loss carryforward, then, of course, only that portion of the future benefit which is reasonably expected to be realized should be recorded as an asset. In determining this value, the accountant should be aware of the fact that even though the enterprise's profit prospects are in serious jeopardy, a potentially valuable asset does nevertheless exist which the firm might well realize by absorbing some profitable firm. An excellent example is provided by the Susquehanna Corporation. Two dissident directors recently gave this company ninety days to come up with a merger or face a battle for control. "They want Susquehanna to find a meger

(sic.) partner so it can take full advantage of a \$12-million tax loss carryover."<sup>23</sup>

Any adjustment to the asset account based on subsequent reevaluations, realization or expiration of the carryforward tax-benefit asset should be recorded as an adjustment of prior years earnings and applied back to the year of the loss in any restatement of prior-year's income.<sup>24</sup>

To illustrate, assume that effective January 1, 19x8, using the data in Table VII, there is a 2 per cent decrease in the corporate normal tax rate. As a result, the "tax reduction benefit" of the carryover has been decreased by 2 per cent of the loss carryover. The following entry should be recorded in 19x8, the year of the decrease:

Retained Earnings (or Adjustment to Prior-	
Years' Earnings) ( $\$100,000 \times 2\%$ )	\$2,000
Future Tax Benefits Arising From Loss	
Carryover	\$2,000

In the case of a tax rate increase, the reverse of the above should be recorded.

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<sup>23</sup>"Susquehanna Corp. Gets Ultimatum on Merger From Dissident Directors," Business Week, April 24, 1965, p. 154.

<sup>24</sup>Although not germane to this discussion, it should be pointed out a separate but related situation arises in the case of quasi-reorganizations which also has interesting income tax implications from a financial reporting standpoint.

### C. SUMMARY

In summary, the investment tax credit controversy centers around two propositions: (1) recognizing all of the credit as a tax expense reduction in the year of the asset acquisition, or (2) spreading the credit over the productive life of the asset. The latter proposal seems to be more justifiable than the former.

Spreading the investment credit over the life of the asset, however, causes a balance sheet classification problem in the interim with respect to the deferred portion of the credit. Of the several solutions offered for this dilemma, considering the credit as an asset reduction seems most reasonable and it is also workable.

In addition to the investment credit, the tax law also provides a windfall bonanza to the corporation which reports an operation loss for tax purposes. The operating loss may be applied against the taxable income of the three previous years, and, if not used up, against the earnings of the five succeeding years.

The benefits derived from operating loss carrybacks should be reflected in the financial statements in the year the loss occurred. Such a procedure is based on sound theoretical grounds and has met widespread acceptance.

Prevailing practice in accounting for the tax loss carryover is unsound both on theoretical grounds as well as from a utilitarian viewpoint of financial reporting. Whenever an expected economic benefit arises from the tax loss carryover, accountants have

unjustifiably omitted it from the list of benefits or assets possessed by the firm. In brief, the balance sheet aspects of tax loss carryovers have too long been neglected.

The procedures suggested in this chapter for accounting for loss carryovers provide for recognizing the benefit gained from operating at a loss. To the extent that costs incurred giving rise to a loss are recoverable, and not down the drain so to speak, these costs should be carried forward on the balance sheet as assets to be matched against the liability arising from later profitable years. This procedure then achieves a proper matching of costs and revenues by requiring that the income tax reductions from the carryover of operating losses be related to the years in which the losses occurred. Thus, the net loss of the year in which the loss occurred, as well as the net income of the other years to which the loss is carried, is more accurately stated. In sum, the recognizing a tax loss carryover as an asset, results in more effective financial reporting within the framework of existing accounting theory.

## CHAPTER VII

### SUMMARY AND CONCLUSIONS

Unquestionably, the federal income tax charge has become one of the most significant financial burdens of U. S. corporations. For this reason, the income tax consequences of all available alternatives become an important consideration of management in every decision in an attempt to mitigate the tax burden. The selection of the legal form of business enterprise is often determined by income tax considerations. The income tax consequences of each capital investment opportunity are carefully weighed. In short, taxes influence to a significant degree the day to day managerial decisions of any profit seeking corporation.

#### Summary of the Problem Area

Actions of individuals and groups of individuals outside of the management arena are also influenced to a large extent by the corporate federal income tax charge. Because of the materiality of the tax levy, the reported earnings of firms are significantly affected. Investors, stockholders, creditors, labor organizations and governmental bodies all need to be clearly informed as to the impact of federal income taxes on the enterprise's operations of the past, present and future.



The premise of this study is that financial accounting has failed to develop realistic, logical and practical solutions to the problems of reporting the financial impact of the corporate income tax charge, when there is a difference in timing of revenue and deductions for accounting and tax purposes. The purpose of this investigation has been to determine the appropriate reporting treatment of the income tax charge which would best fulfill the utilitarian role of financial reporting to third parties and at the same time be consistent with the existing framework of accounting theory.

#### The Theoretical Structure of Financial Reporting

In order to provide a framework for evaluating existing practice, this study first highlighted the key aspects of: (1) the purpose of financial reporting and (2) the theoretical structure of the income statement and balance sheet.

Purpose of financial reporting. Many accountants readily agree that financial reporting to third parties is a prime responsibility of contemporary accounting. In turn, the purpose of financial reporting is to present in a concise form reliable, relevant information concerning the financial affairs of an enterprise.

Financial information is considered to be relevant if it would influence the decision of the user of the data. Therefore, if financial reports are to fulfill their utilitarian role, they must present all significant financial events and consequences known at the time of the statement preparation which may influence the reader

in deriving conclusions concerning the earning potential and present financial position of the enterprise.

Underlying concepts. In order to implement their responsibility for objective, reliable financial statements, accountants have devised several underlying concepts and assumptions including objectivity, conservatism, materiality, full disclosure, matching and going concern. While the topic of reporting income taxes touches upon each of these concepts, two--matching and going concern--play a key role.

Matching involves the process of dividing the stream of costs incurred between the present and the future. The central theme of matching is that expired costs should be associated with current revenues in the income statement while unexpired costs should be assigned to the balance sheet to be matched against the incoming revenue stream of subsequent periods.

The matching process, like many other accounting concepts, is predicated upon the continuity of existence assumption, often called the going concern concept. In the absence of contrary evidence, the life of a business enterprise is assumed to be indefinite.

The structure of financial reports. In attempting to portray the financial position or condition of a firm, accountants have devised a statement, commonly known as the balance sheet, which is divided into three sections: assets, liabilities and owners' equity. While owners' equity is only indirectly relevant, assets and liabilities play a key role in determining the proper placement of income taxes on the balance sheet.

Before an item can be appropriately classified as an asset, it must meet two principal tests: (1) result from some current or past transaction and (2) possess some expected future economic benefit. Liabilities are generally defined as claims against the enterprise arising from past activities or events which require corporate resources for their discharge. In this study certain accounts arising from income tax consequences of selected transactions were tested against these generally accepted definitions for assets and liabilities.

#### The Nature of the Corporate Income Tax Charge

Historically, accountants have been divided in their opinion as to whether the income tax charge is a cost or a distribution of profit, like dividends. Because of the implications of either opinion this study made a brief examination of the accounting and economic nature of the income tax charge with the hope that such an analysis may shed some light on its proper treatment in periodic financial statements.

The accounting nature of the tax charge. There is some support for the viewpoint that income taxes are a distribution of income. The opposing viewpoint holds that income taxes are an expense. A careful analysis of the arguments which are presented in support of both positions reveals that the only conclusion consistent with existing accounting theory holds that the annual corporate income tax charge is a cost to the business and should be treated as a revenue deduction.

The economic nature of the corporate income tax charge. Similarly, an examination of the economic nature of the corporate income tax charge

reveals that the only position consistent with contemporary economic analysis holds that the income tax is a cost of doing business. The tax base is, however, "accounting" profits rather than "economic" profits. Economists are in general agreement that the corporate income tax is not shifted in the short run, meaning that the stockholders must bear the burden of higher taxes.

On the other hand, while there is some difference of opinion, many economists do hold that the corporate income tax is shifted in the long run. These conclusions have important implications in connection with the corporate income tax rate changes which the U. S. economy is currently experiencing. These conclusions imply that any balance sheet tax account which is accumulated over several accounting periods should be adjusted whenever the corporate tax rate is revised.

Since an examination of the accounting and economic nature of the corporate income tax reveals that it is a business cost, then it follows that such a charge should be reflected as a revenue deduction in determining the net income figure. This conclusion is consistent with existing accounting and economic analysis and achieves the utilitarian purpose of financial reporting in that the earning power of the enterprise is more clearly reflected to external users of the earnings statement.

Intraperiod allocation. One technique commonly used in certain instances for reporting income taxes is referred to as intraperiod tax allocation. The objective of intraperiod allocation is to associate the tax effects with the unusual items causing the income

tax to be different from that computed on normal operations. The rationale of such allocation procedures is an attempt to provide a net income from normal activities which is neither inflated by a tax benefit nor deflated by a tax penalty as a result of extraordinary items. Accordingly, it seems that intraperiod allocation is a step toward increasing the utilitarian role of income reporting.

### The Theory of Interperiod Tax Allocation

Without doubt, interperiod tax allocation is one of the most, if not the most, significant issues at stake today in reporting income taxes in financial statements. Interperiod tax allocation demands a careful and penetrating analysis because its practice in most instances has a material impact upon both the reported earnings between years and the reported financial position of the firm. The question of interperiod tax allocation arises in situations where there are differences in timing of revenue and deductions for tax purposes and accounting purposes. At the present time, there is much support for both allocation and nonallocation.

Arguments against allocation. After carefully evaluating the arguments offered in opposition to interperiod allocation, this study concludes that such opposition rests primarily on three propositions: (1) interperiod tax allocation is simply an income normalization device and as such should be rejected; (2) the tax deferral is permanent and therefore should not be recognized in the accounts; and (3) tax allocation accounting involves too much subjectivity and uncertainty, and for this reason accountants should have no part of such techniques.

Arguments for interperiod tax allocation. Each of the arguments advanced against allocation, however, should be carefully evaluated within the framework of existing accounting theory and at the same time, keeping in mind the purpose of financial reporting.

First, tax effect accounting is firmly based in contemporary accounting theory for such procedures simply achieves to a more precise degree an equitable matching of expenses and revenues. In addition, tax allocation more accurately reflects the earning power of the enterprise. Therefore, the contention that interperiod tax allocation is an income normalization device is without basis. If tax effect accounting is found guilty of this charge, then many other accounting treatments must likewise be condemned.

The argument that since tax deferrals are permanent they do not need recognition in the accounts is also unfounded. The conclusions reached in this study are that tax deferrals are no more permanent than accounts payable or equipment accounts. There are continuous additions and reductions to the deferred tax account and, therefore, do need accounting recognition.

Finally, the argument that tax deferral accounting is plagued with too much subjectivity and uncertainty does not provide enough convincing evidence to warrant rejecting this method of sharpening the determination of net income. Interperiod tax allocation is easily embraced by existing accounting theory and does advance the utility of financial reporting, particularly income reporting.

### The Practice of Interperiod Tax Allocation

One of the principal problems associated with the practice of interperiod tax allocation is the proper classification of the resulting tax deferral accounts. Conventional accounting theory holds that all balance sheet accounts must be classified as assets, liabilities or owners' equity. Any other classification scheme would be in violation of the basic balance sheet equation of assets equals liabilities plus owners' equity. Therefore, any proposal to classify the deferred tax credit as a separate section between liabilities and owners' equity is without theoretical support.

Deferred tax credits as liabilities. Many accountants hold that deferred tax credits should be classified as liabilities. However, this proposal is also rejected because such an account does not qualify as a liability as liabilities are generally defined. As of a specific balance sheet date, the deferred tax credit does not represent a claim against the assets of the enterprise for goods or services. It does not represent a legal obligation.

Deferred tax debits as assets. Turning to deferred tax debits, numerous accountants feel that such items should be reported as assets when such accounts arise from the tax revenue initially exceeding the amount of revenue recognized for accounting purposes. Again, such a proposal is contrary to the generally accepted definition for assets.

Tax deferrals as offsets. The recommendation of this study is that the deferred tax accounts arising from timing differences should be related to the account which gave rise to the deferral in the first

instance. Such a treatment is not only consistent with existing accounting theory, but also results in more informative reporting than heretofore has generally been practiced.

Accounting for tax rate changes. Recent corporate tax rate changes have caused one further consideration in regard to tax allocation. That is the question of whether or not the deferred tax account should be adjusted in the face of tax rate changes. This study concludes that due to the inherent nature of the deferral, not to record an adjustment in the case of tax rate changes would be quite inappropriate. A simple, easily understood and straightforward technique is available to accountants for this purpose. .

#### The Investment Tax Credit

It is generally agreed that the role of the investment tax credit in financial reporting is in a state of confusion at this time. A common ground for this issue is yet to be found. The two prevailing opinions are that: (1) the investment tax credit should be treated as a tax expense reduction in the year of the asset acquisition or (2) that the investment credit benefit should be spread out over the life of the asset. Accounting theory seems to be on the side of the latter proposal. The managerial decision to purchase the asset is presumed to have been made with full awareness of all the benefits acquired, including the tax credit benefit. Therefore, these purchased benefits should be allocated as nearly as possible over the productive life of the asset.



### Net Operating Loss Carrybacks and Carryovers

This study concludes that prevailing accounting practice and theory concerning the accounting for net operating loss carrybacks is sound.

In accounting for net operating loss carryovers, however, accounting practice has abdicated its responsibility. While many times loss carryovers are the most valuable assets firms possess, such information is tucked away in a hard to find, and hard to understand, footnote, if reported at all. To the extent that operating loss carryovers possess expected future economic benefits via tax reductions, they should be reported as assets. Such a treatment is consistent with contemporary accounting theory and achieves a greater degree of utility in financial reporting.

In summary, this study has intensively reviewed several highly important areas where corporate income taxes have a significant impact upon the results of financial reporting. In each case prevailing viewpoints and practices were carefully analyzed, synthesized, investigated and evaluated. An attempt was made to determine first, if tax effect accounting is in accordance with contemporary accounting theory and second, if prevailing practice fulfills the utilitarian role of financial reporting to the fullest extent possible.

The results of this investigation suggests that the role accorded corporate federal income taxes in financial accounting in many instances has been unrealistic, inconsistent and inadequate. Inasmuch as governmental expenditures are ever mushrooming into all-time highs, and inasmuch as the income tax is the chief revenue producer used to

finance these record breaking governmental expenditures, the federal corporate income tax charge will continue to have a significant impact upon financial reporting. It behooves the accounting profession to resolve all significant areas of conflict in reporting income tax consequences as well as improve its reporting techniques keeping in mind at all times the principal users and uses of the financial data.

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## VITA

Doyle Zane Williams, the son of Nuell Olin Williams and Lurline Isbell Williams, was born in Shreveport, Louisiana on December 18, 1939.

He received his elementary and secondary education in the Natchitoches Parish public school system and graduated from Ajax High School in May, 1957. In the following September he entered Northwestern State College of Louisiana in Natchitoches. As the Honor Graduate, he received the degree of Bachelor of Science in Accounting in August, 1960.

On August 22, 1960, he joined the staff of Haskins & Sells, Certified Public Accountants, in New Orleans, Louisiana.

Upon being awarded the Humble Oil & Refining Company Fellowship in Accounting at Louisiana State University in Baton Rouge, he enrolled in the Graduate School of that institution in June, 1961. He received the degree of Master of Science in Accounting in August, 1962.

In September, 1962, he re-enrolled in the Graduate School of Louisiana State University in Baton Rouge. From September, 1962 to June, 1964, he served as a Graduate Teaching Assistant and 1964-65 as an Instructor in the Department of Accounting. He was the 1963-64 recipient of the Haskins & Sells Foundation Teaching Assistance Grant. On January 31, 1964, he received his Certified Public Accountant's

certificate from the State of Louisiana. He is currently a candidate for the degree of Doctor of Philosophy in Accounting.



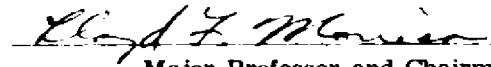
## EXAMINATION AND THESIS REPORT

Candidate: Doyle Zane Williams

Major Field: Accounting

Title of Thesis: Determination of the Role of the Corporate Federal Income  
Tax in Financial Reporting

Approved:

  
Major Professor and Chairman

  
Dean of the Graduate School

### EXAMINING COMMITTEE:











Date of Examination:

June 22, 1965